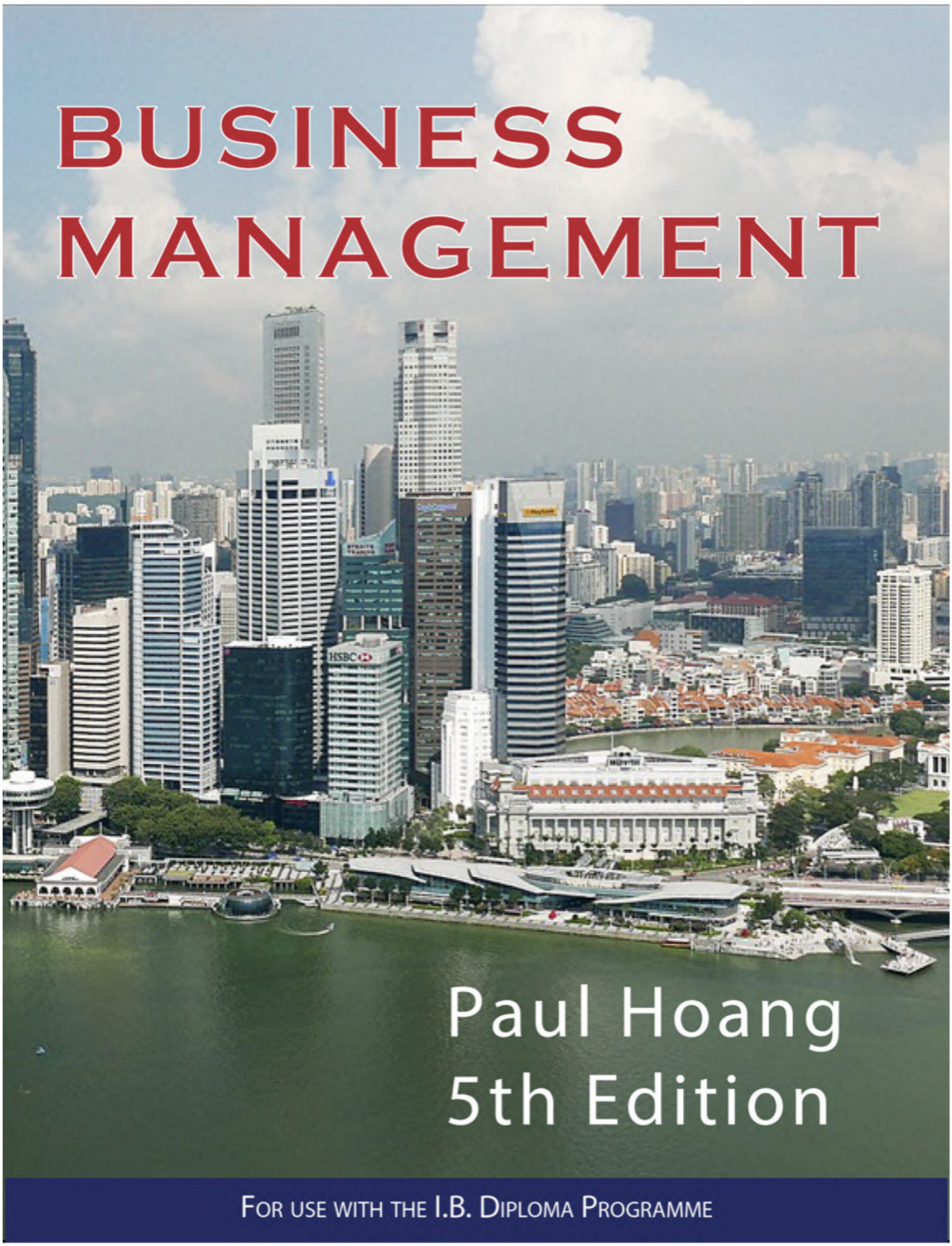
BUSINESS MANAGEMENT



Paul Hoang

5th Edition

FOR USE WITH THE I.B. DIPLOMA PROGRAMME

INTERNATIONAL BACCALAUREATE

Business Management

FIFTH EDITION

E-Book

Paul Hoang



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Dedication

Dedicated to Kin, Jake, and Luke, for always.

About the author

Paul Hoang has taught Economics and Business Management for over 25 years. He has held the position of Vice Principal and IB Diploma Programme Coordinator at an internationally renowned IB World School in Hong Kong. He was previously Head of Department at two schools in London. He is also an examiner for multiple examination boards. Paul is a highly experienced IB Educator, with over 15 years of experience as an IB Workshop Leader, having led workshops in Business Management, Economics, TOK and the Extended Essay in Europe, Asia Pacific, and the USA.

Paul is Site Author of *InThinking Business Management*, which is used by the majority of IB World Schools. Paul is also Subject Leader for IB Economics and IB Business Management at *ManageBac*. He serves as a partnering consultant for *IB School Improvement*, focusing on the use of assessment data to enhance teaching and learning. He has also been an educational consultant at his alma mater, The Institute of Education, University of London, UK.

Aside from work, Paul is a qualified 2nd Dan World Taekwondo instructor and enjoys play 5-a-side football on a regular basis. Being a Londoner, he is a passionate follower of Arsenal Football Club, but realizes no one is perfect! Most important though, Paul enjoys spending family time with his wife and two sons.

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Paul Hoang with some of his Business Management students

Author's acknowledgements

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Paul Hoang

Acknowledgements

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How to use this book

At a glance

- This book follows the format of the IB Business Management syllabus (first examination in 2024). It is a dedicated text for both the Standard Level (SL) and Higher Level (HL) courses.
- Units and sections that only apply to HL students are clearly highlighted.
- The textbook contains 230 examination-style questions. Case studies from around the world have been used in these questions to signify the international nature of IB Business Management.
- There are 115 examination tips that appear throughout the text.
- Over 145 Theory of Knowledge questions are integrated in the text.
- 740 key terms (definitions) clearly defined.
- 125 key concepts links throughout the textbook.
- 60 ATL Activities are also included as part of the IB teaching and learning pedagogy.
- 70 Business Management Toolkit links have been included in the 5th edition.
- This book is not intended to be read chronologically; the format simply matches the order in the IB Business Management syllabus guide. Your teachers will be able to guide you further.
- All currencies are expressed in American dollars (USD). Where case studies refer to other currencies, these have been converted into the USD equivalent for ease of comparison

Features of each chapter

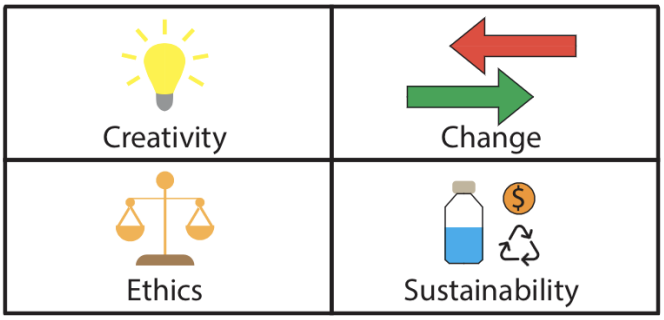
- The contents at the beginning of each chapter shows the specific aspects that are covered, based on the Assessment Objectives (AO) in the syllabus guide.
- Exam-style questions appear throughout the textbook. These are based on examination-style questions to give you plenty of practice.
- Each Unit has linkages to the four key concepts that are integral to the nature and essence of the IB Business Management course: creativity, ethics, strategy, and change (CESC). This serves to ensure that both SL and HL students have a more holistic appreciation and understanding of Business Management through the four conceptual lenses.
- Review questions test your understanding of the contents covered in each chapter. These are based on the chronological order of the text, making it easier for you to follow and check your own understanding.
- Integration of the Business Management Toolkit (BMT) appear throughout the textbook. There are right parts to the BMT for SL students and a total of fifteen tools in the BMT for HL only students.
- Key terms are summarized and defined at the end of each chapter. The key terms appear in alphabetical order to make searching easier. There are 740 definitions in the textbook.

About this book

This is the fifth edition of Paul Hoang's bestselling Business Management textbook for the IB Diploma Programme (first exams 2024).

The content has been revised throughout to match the new syllabus (first teaching 2022). Features of the 5th edition include:

- More than 230 exam-style questions, with full mark schemes available to support teachers and students.
- 740 key terms identified and clearly defined.
- Chapter review questions for student reflections.
- Clear links to the four key concepts in the Business Management course: Change, Ethics, Sustainability and Creativity (CESC). These concepts help students to think about Business Management in a more holistic, interdisciplinary and critical way



The new "CESC" concepts in Business Management

- More than 110 examination tips and over 40 common mistakes to avoid in the exams.
- 145 Theory of Knowledge (TOK) questions are integrated throughout the textbook, along with 60 ATL Activities to engage students in their learning and making connections of the tools, theories and techniques in Business Management.
- Over 100 short case studies are included to encourage students to apply their learning to the context of real-world business organizations.
- Coverage of the Business Management Toolkit (BMT), with 40 exam practice questions for this component of the course.
- Advice for concept-based learning (CBL), the Internal Assessment (for SL and HL), the external assessments (Papers 1, 2 and 3), as well as the Extended Essay in Business Management.

An accompanying **Answer Book** is available from IBID Press with full mark schemes for all exam practice questions in the 5th edition textbook (http://www.ibid.com.au/business-management/).

Testimonials

"This textbook is, unquestionably, the standard to which all other books attempt to measure up."
Marc Brothers, Indonesia

"Thank you very much for this textbook – I really, truly appreciate this! From everything that I have seen and read, Paul Hoang is the leader within the IB Business Management field."
Pam Monte Zosa, Uruguay

"Let me please reiterate my thanks for your wonderful book. My students and I are enjoying it immensely - it reads and flows so well."
Bettina Hoar, USA

"Sincere thanks to Paul as this textbook makes the students' lives (and ours too!!) so much easier, being so well tailored to the IB requirements, with excellent and relevant real-world examples."
Roxie Burnes, United Kingdom

"Simply the best textbook for the IB Business Management course – my students just love the book!"
Matt Temp, Canada

"If you are teaching this subject at an IB school, there is no other choice – it has to be Paul Hoang's textbook, you will not regret it. I cannot recommend his work enough, it is now in the 5th edition and better than ever and has helped my students out tremendously."
Fabrice Vanegas, Thailand

"Your book is my absolute favourite for IB Business Management! Honestly, I wouldn't be without it. It adds so much extra than the typical course textbook – thank you!"
Helen Staniland, UAE

"I would like to offer my gratitude to you for your amazing book, which has helped me to understand the many aspects of Business Management. Your case studies really make the understanding of everything much easier. We have been using your textbook from Day 1 and honestly surviving IB BM would have been impossible without it!"
Yatharth Dhoot, Tamil Nadu, India (IB DP student)

"Can I just start off by saying that you are my idol! Your chapter on marketing in the business management textbook for IB students inspired me to pursue marketing in my future studies... I would really like to thank you for putting all your effort into this book and giving us IB students a very clear and helpful book. I would not have been able to get through this BM course without your in depth explanations and up-to-date and relatable examples. This book has also helped us understand concepts easily. I really appreciate you for being an inspiration to us young students and helping us realise our dreams"
Neha Bhojwani, IB student

"I've studied your Business Management book at the British International School Vietnam while completing the IB Diploma. I am a great enthusiast of your work."
Evan Planchon, IB student

"Hoang's textbook is the best when it comes to complex ideas and really going in depth. The questions inside the book really helped with my exams."
Sohm Naran, IB student of Harare International School, Zimbabwe

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David Dachpian, Poland

"Your textbook does an excellent and thorough job of explaining everything."
Jennifer Jones, Norway

"We study with your excellent book. It has so useful tips and everything is said so clearly. Thank you for that!"
Pia Hartonen, Finland

"My IB Business Management class has been using your book for the past 2 years now. I just want to give my thanks for writing this amazing book. It is truly a life saver. Thank you."
Edward Liu, Hong Kong

"There is only one textbook that I would recommend - Paul Hoang's."
Dr. Rima Puri, Senior IB Examiner

"We used your Business Management textbook for HL class. The book was our companion during our sleepless nights as it guided us through our IA and EE. Both of us are majoring in business in universities now and we just wanted to say that your book has helped tremendously and prepared us in our current studies. Thank you for your contributions to our academic success. We hope you continue to motivate future students with your exceptional works."
Sam Castillo (University of Colorado) and Eunice Lee (University of Washington)

"We have been purchasing your textbook for more than 10 years and believe it is the most valuable textbook for IBDP Business Management students."
Shirley Zhang Zheng, Head of Individuals and Societies, Shanghai Pinghe School, China

"Paul Hoang - Thanks so much ... your book is hands down the best."
Maria Manos

"This resource is absolutely brilliant, containing a variety of exercises to test students' learning and understanding. It saves me so much time, and my lessons are planned much more efficiently with this resource to rely on. Just brilliant!"
Harry Butch, Indonesia

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Chapter 1

Unit 1.1 - What is a business?

"It does not take much strength to do things, but it requires a great deal of strength to decide what to do."
Elbert Green Hubbard (1856 – 1915), American author and philosopher

Contents

1.1 What is a business?	
SL/HL content	**Depth of teaching**
The nature of business	AO1
Primary, secondary, tertiary and quaternary sectors	AO2
Challenges and opportunities for starting a business	AO2

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The nature of business (AO1)

A **business** is a decision-making organization involved in the process of using inputs to produce goods and/or to provide services (see Figure 1.1). *Inputs* are the resources that a business uses in the production process, such as labour and raw materials. This process generates *outputs* (also known as products). Management guru Peter Drucker said that *"there is only one valid definition of business purpose: to create a customer"* by creating goods and services that meet the needs and wants of customers.

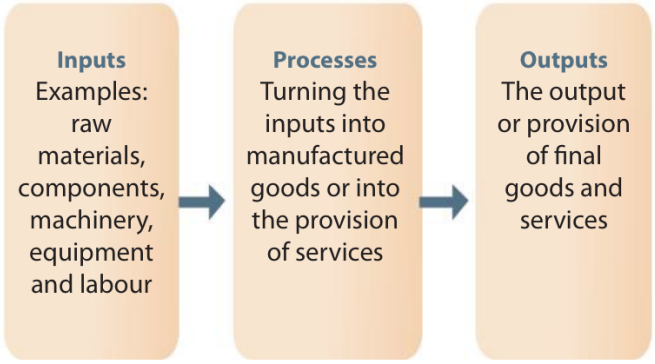

Figure 1.1. The production process

The term **product** can refer to both goods and services. **Goods** are physical products, such as smartphones, clothes, books and food. **Services** are intangible products, such as haircuts, public transport, education and healthcare. Businesses can also provide goods and services to other organizations, such as freight transportation, distribution and insurance.

An **entrepreneur** is the individual who plans, organizes and manages a business and its operations, taking on financial risks in doing so. The term was coined by Richard Cantillon (1680 - 1734) an Irish-French economist. Entrepreneurship describes the trait of business leaders who tend to be distinctive in their temperament, attitude and outlook who drive the business to achieve its organizational goals. Successful entrepreneurs tend to be creative, innovative and highly passionate. They search for and exploit business opportunities by forecasting and/or responding to changes in the marketplace.

The nature or purpose of business activity is to generate **added value**. This occurs when there is a positive difference between the selling price of a product and the cost of producing the good or service. Added value exists when products are appealing to customers, so they are willing to pay a higher price for such items.

Management guru Peter Drucker (1909 - 2005) famously said that the only purpose of a business is to create customers, i.e. the role of businesses is to combine human, physical and financial resources to create goods and services in order to satisfy the *needs* and *wants* of people, organizations and governments. **Needs** are the basic necessities that people must have to survive, such as food, water, warmth, shelter and clothing. **Wants** are people's desires, i.e. the things they would like to have, such as a larger home, a new smartphone, an overseas holiday or a birthday cake.



Figure 1.2 - Cakes are a desire, not a need

Case study 1.1 - Steve Jobs

Steve Jobs (1955 - 2011), the co-founder of Apple, did not graduate from university because his adopted parents could not afford the tuition fees. Instead, he took the risk of setting up Apple with two friends (Steve Wozniak and Ronald Wayne) in 1976. However, Ronald Wayne sold his share of the company within a couple of weeks for (just) $2,300. Jobs went on to reinvent computing, music and mobile phones, making Apple the highest valued company in the world, just two months before he died. *Forbes* estimated the wealth of Jobs to be over $8.3 billion.

Common mistake

The terms **customer** and **consumer** are often used interchangeably by students, although they have different meanings. Make sure you can distinguish between the two terms and use them in the right context - *customers* are the people or organizations that purchase a product whereas *consumers* are the ones who actually use the product. These may be the same entity (e.g. someone who buys and eats a meal), but not necessarily such as parents (customers) who buy presents for their children (consumers).

Box 1.1 - Types of products

- **Consumer goods** are products sold to the general public, rather than to other businesses. They can be further categorised as *consumer durables* (products that last a long time and can be used repeatedly, such as electronic devices, motor cars, jewellery, clothes and home furniture), or *non-durables* (those that need to be consumed shortly after their purchase as they do not last or cannot be reused, such as fresh food items, beverages, medicines and newspapers).
- **Capital goods** (or **producer goods**) are physical products bought by businesses to produce other goods and/or services. Examples include buildings (premises), computers, machinery, tools and specialist equipment.
- **Services** are intangible products provided by businesses. The service is not tangible, but the results or experiences are, such as healthcare, transportation, dining, sports (recreation), legal advice, financial guidance and education.

For a business to operate effectively, tasks must be carried out by various functional areas (or departments). These interdependent functional areas are human resources, finance and accounts, marketing and operations management. The nature of business requires these main functional areas to work together in order to achieve the organization's goals.

1. **Human resource management** – The human resources (HR) department is responsible for managing the personnel of the organization. This includes roles such as human resource planning, organizational structures, management

and leadership, motivation and demotivation and dealing with industrial/employee relations (see Chapters 7 - 13).

2. **Finance and accounts** – The finance and accounts department is responsible for managing the organization's money, ensuring compliance with legal requirements (such as filing of corporate taxes) and informing those interested in the financial position of the business (such as shareholders and potential investors). Finance and accounts topics are covered in Chapters 14 - 22.

3. **Marketing** – The marketing department of a business is responsible for identifying and satisfying the needs and wants of customers. It is ultimately in charge of ensuring that the firm's products sell. This is done through a series of activities such as market research, promotion, pricing, branding and distribution. The nature of marketing as a business function is covered in Chapter 23 - 34.

4. **Operations management** – This functional area of a business is responsible for the process of converting raw materials and components into finished goods, ready for sale and delivery to customers. Examples of production include the extraction of crude oil, car manufacturing and the provision of travel and tourism services. Operations management topics are covered in Chapters 35 - 43.

A large organization is able to allocate resources to each of these four functional areas, making their roles easily identifiable. In a small business, owned by just one person, each function would need to be carried out by the same person. In practice, the interrelated nature of four functional areas of a business mean that the operations management department relies on effective marketers to promote and sell their products. Equally, marketers can only do their jobs if they have well-made products to sell and the necessary financial resources to do so.

Question 1.1 - The business of education



Education is big business. Schools can earn **revenue** from numerous sources, such as tuition fees (for fee-paying schools), grants from the government and fund-raising events. They might also lease out their facilities (such as classrooms, sports facilities, drama studios and swimming pools) during the evenings, weekends and school holidays.

Schools use these revenues to finance their **costs**, such as staff salaries, utility bills and the maintenance of the buildings. In addition to school fees, parents might also have to pay for items such as school uniform, textbooks, stationery, sports equipment and food.

(a) Distinguish between *revenue* and *costs*. *[4 marks]*

(b) Examine how business functions operate in an organization such as a school. *[6 marks]*

Primary, secondary, tertiary and quaternary sectors (AO2)

Businesses can be classified according to the stage of production (or chain or production) that they are engaged in. These stages are categorized as (i) primary, (ii) secondary, (iii) tertiary and (iv) quaternary sectors.

(i) Primary sector

Businesses operating in the primary sector are involved with the extraction, harvesting and conversion of natural resources. Examples include agriculture, fishing, mining, forestry and oil extraction. Primary sector business activities tend to account for a large percentage of output and employment in low-income countries. Businesses operating in the primary sector in high-income countries use mechanisation and automation, such as combine harvesters, tractors and automatic watering systems.

As countries achieve sustained economic growth and development, there is less reliance on the primary sector in terms of employment and national output, partly because there is little added value in primary sector production. For example, low-income countries can only sell tea leaves and coffee beans at relatively low prices. Nevertheless, the primary sector is important for all countries. For example, even though less than 4% of France's national output comes from the primary sector, the country benefits immensely from its agricultural exports sold all around the world.



Figure 1.3 - Agricultural farming is part of the primary sector

(ii) Secondary sector

Businesses that operate in the secondary sector are involved in manufacturing or construction. Examples include clothes manufacturers, publishing firms, breweries and bottlers, construction firms, electronics manufacturers and energy production companies. The output is then sold to customers, such as other businesses, governments, foreign buyers or domestic customers.

Medium-income countries tend to have a dominant secondary sector that accounts for a relatively large proportion of their country's national output. Economists argue that the secondary sector is the wealth creating sector because manufactured goods can be exported worldwide to earn income for the country. Value is added to the natural resources used during the production process. For example, the mass production and export of motor vehicles and consumer electronic products has helped economies such as Taiwan and South Korea to prosper. However, automation and mechanisation in modern societies have caused a decline in many secondary (manufacturing) industries in terms of employment.



Figure 1.4 - Construction is part of the secondary sector

(iii) Tertiary sector

Businesses that operate in the tertiary sector specialize in providing services to the general population and other organizations. Examples of industries in the tertiary sector include retailing, transportation and distribution, banking, finance, insurance, healthcare, leisure and tourism and entertainment.

Note that physical goods can be transformed in the process of providing a service. This happens in a restaurant when the chef prepares a meal with fresh ingredients. Nevertheless, the focus is on the people who are providing the service - the chef and the waiting staff who serve the diners - rather than on the tangible product itself.

In high-income countries, the tertiary sector tends to be the most substantial sector in terms of both employment and output as a percentage of *gross domestic product* (the value of the country's output each year). For example, in the USA and UK, around 80% of the labour force work in the tertiary sector. The decline of the manufacturing sector in high-income countries also signifies their growing reliance on the tertiary sector.



Figure 1.5 - Public transportation is part of the tertiary sector

(iv) Quaternary sector

This is a sub-category of the tertiary sector. Businesses that operate in the quaternary sector are involved in intellectual and knowledge-based activities that generate and share information. Examples include information communications technology (ICT), research and development (R&D), consultancy services and scientific research. For example, pharmaceutical companies invest heavily in R&D to create innovative products, develop new production methods, improve efficiency and to tap into markets. The quaternary sector exists mainly in high-income countries as it requires a highly educated workforce. It is also the sector in which high-tech and e-commerce businesses invest for further growth and evolution.



Figure 1.6 - Information Communications Technology (ICT) is part of the quaternary sector

The four business sectors are linked through the **chain of production** which tracks the stages of an item's production, from the extraction of raw materials used to make the product all the way through to it being delivered to the consumer (see Figure 1.1).

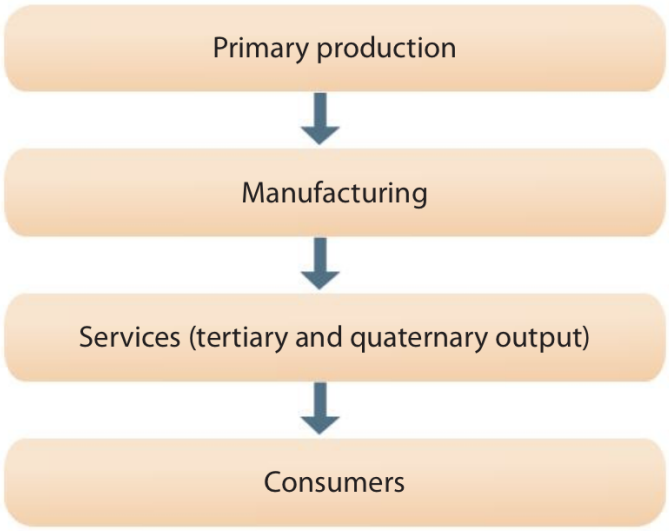

Figure 1.7 - The chain of production

All four business sectors are *interdependent* because each sector relies on the others to remain in existence. For example, raw materials such as crude oil, would not be extracted if there was no need for oil refinery whilst there would not be any need for oil refiners if there were no customers for the oil, such as motorists and airline companies in the tertiary sector. Likewise, firms in the secondary sector rely on their suppliers for stocks to ensure that their production targets are met. Businesses are also interdependent as they all need energy, ICT facilities, manufactured producer goods, financial services and management consultants.

High-income countries are able to exploit the tertiary and quaternary sectors as the main contributors to national output and employment. Businesses such as Apple and Samsung see themselves as operating in the services sector (they outsource production of their smartphones and computer hardware to manufacturers such as Foxconn). Apple realise that there is more added value in the tertiary and quaternary sectors - rather than receiving one-off payments from selling manufactured equipment, it can receive a flow of revenue from offering after-sales services such as maintenance and support services.

Question 1. 2 - Production Sectors

Study the data below and answer the questions that follow. A, B and C represent three countries: France, Bangladesh and the Philippines (although not necessarily in that order).

Structure of employment (%)

	A	B	C
Agriculture	33	4	45
Manufacturing	15	24	30
Services	52	72	25

(a) Identify the countries A, B and C. *[3 marks]*

(b) With reference to the data above, explain your answer to Question 1.2 (a). *[6 marks]*

https://en.wikipedia.org/wiki/List_of_countries_by_sector_composition_of_the_labor_force

Challenges and opportunities for starting a business (AO2)

CORE

Results from around the world consistently show that around 20-25 per cent of new businesses fail to survive their first year. A new business is likely to face challenges which must be dealt with immediately to prevent them from escalating and threatening its survival. The challenges for starting up a business include any combination of the following:

- **Lack of finance** - All businesses need finance for the purchase of *fixed* assets, such as premises, buildings, machinery and equipment. However, start-up firms and most owners of new or small businesses do not have the credentials to secure sufficient funding without major challenges. Even if entrepreneurs are able to some borrow money, the funds may be insufficient or the relatively high interest charges might seriously affect the cash flow position of the business (see Chapter 20). Hence, new sole traders (see Chapter 2) often have to remortgage their own homes to raise the finance needed, thereby offering the lender more *collateral* (financial security) in case they fail to repay the loan).

- **Unestablished customer base** - A major challenge facing new businesses is attracting customers, i.e. building a broad and loyal customer base. The problem is intensified when there are well established competitors that already operate in the market. Customer loyalty is built over a long period of time, which may require marketing know-how and large amounts of money.

- **Cash flow problems** - Financing *working capital* (the money available for the daily running of a business) is a major challenge for many business start-ups. A business might have a lot of stock, such as raw materials, semi-finished output or finished goods that it cannot easily turn into cash. Customers might demand a lengthy credit period (typically between 30 to 60 days) enabling them to buy now and pay later, so the business will not receive the cash payment until the credit period is over. However, during this time, the business still needs to pay for its on-going costs such as wages, rent, utility bills, taxes and interest payments on bank loans.

- **Marketing problems** - Marketing challenges arise when businesses fail to meet customer needs, thereby resulting in poor sales and a lack of profitability. Supplying the right products to the right customers at the right price is especially crucial for new businesses. However, small and new businesses might lack the expertise to do this. Quite often, the key to small business success is to identify a *niche* (or gap) in the market and then fill it. For example, back in the 1990s, Amazon identified huge opportunities of using the Internet as a channel of distribution for books and other products. European airline carriers such as easyJet and Ryanair identified early on the niche market for no-frills (budget) air travel.

- **People management problems** - Business start-ups may lack experience in hiring the right staff with all the necessary skills. This can lead to poor levels of labour productivity and the need to retrain staff or to rehire people, all of which can be very expensive and time consuming. Moreover, new businesses might not know the ideal organizational structure (see Chapter 8) or the most practical methods of staff motivation (see Chapter 10) that best suits their organizational needs.

- **Production problems** - It can be challenging for business start-ups to accurately forecast levels of demand so they are more likely to either over produce or under produce. Overproduction tends to lead to stockpiling, wastage and increased costs (see Chapter 40). By contrast, underproduction leads to dissatisfied customers and a loss of potential sales.

- **Legalities** - It is necessary for businesses to comply with all necessary legislation, including business registration procedures, insurance cover for staff and buildings, consumer protection laws and rules about intellectual property such as copyrights, patents and trademarks (see Chapter 42). The paperwork and legal requirements of setting up a new business can be cumbersome, confusing, time consuming and expensive. Any oversight could result in the business having to pay compensation or financial penalties. This would obviously damage the already vulnerable cash flow position of business start-ups.

- **High production costs** - New businesses are likely to have high set-up costs (see Box 1.2) and running costs due to the large amount of money needed to purchase or pay for capital equipment, machinery, stocks (inventory), rent, advertising, insurance and so forth. Smaller businesses will also be at a cost disadvantage as they cannot benefit from economies of scale (see Chapter 5). By contrast, economies of scale allow larger and more established businesses to benefit from lower average costs of production due to the size of operations, such as being able to get discounts from their suppliers for large bulk purchases or being able to borrow money at a lower interest rate because of their larger size and financial collateral.

Box 1.2 - Examples of start-up costs for a new business

- Buildings, such as alterations, fixtures and fittings and insurance costs.
- Capital equipment, such as office furniture, telephones, computers, Wi-Fi, machinery, tools and motor vehicles.
- Human resources, such as recruitment, induction and training costs.
- Legal and professional fees, such as the costs of solicitors, licenses and permits.
- Marketing costs, such as market research, advertising and promotional campaigns.
- Premises, such as purchase costs, mortgage deposit payment or rental deposit costs.

- **Poor location** - Businesses face a dilemma in the location decision: busy areas offer the highest potential number of customers, but the premises in these areas will also cost the most (see Chapter 38). Fixed costs, such as rent or mortgage payments, account for a large percentage of total costs for many businesses. An aim for any new business is to reach break-even as soon as possible, by keeping fixed costs down. This is one reason why many entrepreneurs set up small businesses that operate initially from their own homes (which also has some tax advantages). Jeff Bezo, the founder of Amazon, started his online business in his garage. Of course, this option is not suitable for businesses where location (see Chapter 38) plays a key factor in business survival.

- **External influences** - All businesses, irrespective of size or how long they have been in operation, are prone to exogenous shocks (see Chapter 46) that create a challenging trading environment, such as a global financial crisis or the outbreak of a pandemic. However, larger and more established firms tend to be better resourced to handle these external influences. Hence, new businesses face the added challenge of being more vulnerable to external shocks which also means the potential for business failure is greater.



Figure 1.8 - The COVID-19 pandemic caused havoc for businesses across the world

However, there are many potential opportunities for starting up a business. These opportunities can be remembered by the mnemonic GET CASH©.

- **Growth** - Entrepreneurs tend to benefit personally when there is an appreciation in the value of their businesses, especially as property and land tend to increase in value over time. This is called *capital growth*. It is quite common for the capital growth of a business to be worth more than the value of the owners' salaries. Bill Gates, who co-founded Microsoft in 1975, made his fortunes mainly from the capital growth of Microsoft, the world's largest software maker.

- **Earnings** - The Chinese have a saying that "*You can never get rich earning money from working for someone else.*" That is because the potential returns from setting up your own business can easily outweigh the costs, even though the risks are high. It is common that entrepreneurs earn far in excess of salaries from any other occupation that they might otherwise pursue. Tim Cook, CEO of Apple, is reported to have an annual remuneration package of around $265 million whilst Elon Musk, Tesla's CEO, is paid around $595 million a year!

- **Transference and inheritance** - In many societies, it is the cultural norm to pass on assets, including businesses, to the next generation. Many self-employed entrepreneurs view their business as something that they are able to pass on (transference) to their children (inheritance) to give them a sense of financial security that might not be possible if they chose to work for someone else. The Walton family (the richest family in the world with an estimated wealth of over $215 billion) own over 50% of the shares in Walmart, the world's largest retailer. The Mars family is the second wealthiest family, with an estimated wealth of $120 billion. Mars Inc., a privately held company (see Chapter 2) that produces confectionary, processed foods and veterinary services is a multigenerational family business that was founded in 1911.

- **Challenge** - Some people might view setting up and running a business as a personal challenge. It is this challenge that drives them to perform and what gives them particular satisfaction. Being successful in business boosts self-esteem. This is perhaps one reason why multi-billionaires such as Warren Buffet, Carlos Slim and Li Ka-shing continued to work past the official retirement age.

- **Autonomy** - Working for someone else means exactly that. Employees have to follow the instructions and rules set by the organization that they work for, such as the conditions of employment, working hours, employment benefits and holiday entitlement. Conversely, being self-employed means that there is autonomy (independence, freedom of choice and flexibility) in how things are done within the organization. Essentially, this opportunity refers to the benefits of being your own boss.

- **Security** - Similarly, there could be a greater sense of job security for someone who is their own boss. By contrast, employees can be dismissed, made redundant or even replaced by technology. Although the risks are great, being self-employed also makes it potentially easier to accumulate personal wealth (financial security) to provide higher funds for (early) retirement.

- **Hobbies** - Some people might want to pursue their passion or to turn their hobby and interests into a business opportunity. Successful entrepreneurs have a passion for what they do and this is made easier if the nature of the work is directly related to their personal interests. Top selling author, J.K. Rowling is an example. Jamie Oliver, the celebrity chef, has set up several of his own restaurants. Internet entrepreneur Mark Zuckerberg became the world's youngest billionaire when he was just 23 years old, having co-founded Facebook and becoming the company's CEO.

In summary, people set up their own businesses due to the opportunities to satisfy their personal desires - such as to fulfil a personal vision, to have the opportunity to achieve success, to be their own boss or simply to live a more extravagant lifestyle (if and when the business becomes a 'success'). However, a

significant number of new businesses fail to survive. There are three inter-related reasons or challenges behind this: a lack of cash in the business, poor cost control and substandard or weak management and leadership.

Key concept

How important is **creativity** for business success?

Theory of Knowledge (TOK)

Reflect on the opportunities for starting up a business. How do *reason* and *emotion* interact to affect the decision-making process? Is *emotion* or *reason* more important in this process?

Theory of Knowledge (TOK)

To what extent is luck an essential part of being successful in business? How does this impact the knowledge needed to succeed as an entrepreneur?

Business Management Toolkit

Discuss how the use of a business plan (see Chapter 48) can help entrepreneurs to tackle the challenges and opportunities of starting a business.

What is a business? and the key concepts

Business activity is the process of turning inputs (land, labour, capital and enterprise) into outputs (finished goods and services) in order to meet the needs and wants of different customers. Irrespective of the country or culture, all businesses strive to add value in the production and provision of goods and services as part of their sustainable business strategy.

The reasons for setting up a business can vary from one country and culture to another. For example, only a few legal procedures are needed to establish a business in Singapore, Hong Kong and New Zealand, thus promoting an entrepreneurial culture where creative and innovative businesses can thrive. In other places, such as Chad, Libya and Myanmar, a risk-taking entrepreneurial culture is not so apparent, so there is relatively little change and sustainability is more of an issue.

Essentially, the nature of business activity is to satisfy the needs and desires of customers whilst fulfilling the organization's own objectives, such as profit, growth and corporate social responsibility (see Chapter 3). In the long run, all businesses must generate profit or surplus in order to survive, although there will be similarities and differences in how for-profit and not-for-profit organizations go about doing this (see Chapter 2). Complexities in the global corporate world mean that change, ethics and creativity are central to the sustainability of businesses.

Case study 1.2 - Paul Buchheit and Gmail

Creativity and the ability to adapt to change are crucial skills to compete successfully in the corporate world. Paul Buchheit, an employee of Google, is credited as the creator of Gmail. In 2001, he programmed the first working version of Gmail in just one day(!) and was the lead developer. He left Google in 2006 and worked at Facebook until 2010. In 2011, Buchheit won The Economist Innovation Award for the computing and telecommunications field.

Key concept

Discuss the extent to which **sustainable** business practices can enhance an organization's chances of financial success.

REVIEW QUESTIONS

1. What is a business?
2. How do goods and services differ from each other?
3. How do needs and wants of consumers differ from each other?
4. How do customers and consumers differ from each other?
5. What are the four functional areas of a business?
6. What are the four business sectors of the economy?
7. How does a business add value to its goods and services?
8. What is meant by the chain of production?
9. What are the main challenges for business start-ups?
10. What are the main opportunities for business start-ups?

KEY TERMS

Adding value is the practice of producing a good or service that is worth more than the cost of the resources used in the production process.

Businesses are organizations involved in the production of goods and/or the provision of services.

Consumers are the people or organizations that actually use a product.

Customers are the people or organizations that buy the product.

Entrepreneurs are the people who manage organize and plan the resources needed for business activity in pursuit of organizational objectives. They are risk takers who exploit business opportunities in return for profits.

Entrepreneurship refers to the collective knowledge, skills and experiences of entrepreneurs.

Goods are physical products produced and sold to customers, such as laptops, books, contact lenses, perfumes and children's toys.

Needs are the basic necessities that a person must have to survive, including food, water, warmth, shelter and clothing.

Primary sector refers to businesses involved in the cultivation or extraction of natural resources, such as farming, mining, quarrying, fishing, oil exploration and forestry.

Production is the process of creating goods and/or services, adding value in the process.

Quaternary sector is a sub-category of the tertiary sector, where businesses are involved in intellectual and knowledge-based activities that generate and share information, such as research organizations.

Secondary sector refers to businesses concerned with the construction and manufacturing of products.

Services are intangible products sold to customers, such as the services provided by airlines, restaurants, cinemas, banks, health and beauty spas, schools and hospitals.

Tertiary sector refers to businesses involved with the provision of services to customers.

Wants are people's desires, i.e. the things they would like to have, such as new clothes, smartphones, overseas holidays and jewellery.



Figure 1.9 - Holidays are common wants (desires)

Chapter 2
Unit 1.2 - Types of business entities

"To open a business is very easy; to keep it open is very difficult."
- Chinese Proverb

Contents

1.2 Types of business entities	
SL/HL content	**Depth of teaching**
Distinction between the private and the public sectors	AO2
The main features of the following types of organizations: • Sole traders • Partnerships • Privately held companies • Publicly held companies	AO3
The main features of the following types of for-profit social enterprises: • Private sector companies • Public sector companies • Cooperatives	AO3
The main features of the following types of non-profit social enterprises • Non-governmental organizations (NGOs)	AO3

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Distinction between the private and the public sectors (AO2)

Organizations that operate in the **private sector** are owned and controlled by private individuals and businesses, rather than by the government. They differ in size, ranging from those owned and run by just one person, to large multinational companies that operate across the world. The main aim of most, although not all, private sector organizations is to earn **profit** for its owners, i.e. the positive difference between a firm's **sales revenue** (the money earned from selling its products) and its **costs** (production expenditures such as wages and rent).

Organizations that operate in the **public sector** are under the ownership and control of the government. They typically provide essential goods and services that would be underprovided or inefficiently provided by the private sector, e.g. health care, education, social housing and the emergency services. Organizations that are partially or wholly owned by the government are called **public sector companies** (or **state-owned enterprises**, such as the UK's Transport for London, Singapore Airlines, Airports Authority of India and Canada Post (postal services).



Figure 2.1 - Emergency services are provided by the public sector

Case study 2.1 - Australia Post

Australia Post (www.auspost.com.au), established in 1809, is a state-owned enterprise providing postal services. It employs more than 35,000 people across its network of over 4,330 retail outlets, enjoying revenues in excess of AUD7.5bn (USD5.45bn).

Reasons for public sector business activity include:

- To ensure that everyone has access to basic services such as education, health care, museums, public parks and public libraries.
- To avoid wasteful competition as the government is able to achieve huge *economies of scale* (cost savings from operating on a large magnitude) in the provision of certain services, such as postal services and national defence.
- To protect citizens and businesses through institutions such as the Police and the courts that govern the country's law and order system.
- To create employment opportunities, e.g. governments tend to be a large employer of teachers, doctors and nurses.
- To stabilise the economy, e.g. many private sector commercial banks were *nationalised* (bought by the government) during the global credit crisis of 2008 to prevent further financial turmoil. Government intervention throughout the COVID-19 global pandemic also helped to stabilise the world's economies.

Question 2.1 - The private and public sectors

Education, housing and healthcare services can be provided by both private sector businesses and the public sector.

(a) Distinguish between the aims of organizations operating in the public sector and the private sector. *[4 marks]*

(b) Examine how housing provided by a housing cooperative might differ from that provided by a private sector business. *[6 marks]*

Types of organizations (AO3)

The main features of the following types of organizations: (i) sole traders, (ii) partnerships, (iii) privately held companies and (iv) publicly held companies. AO3

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Most businesses that operate in the private sector aim to make profit. After all, a business can only survive in the long term if it is profitable. Profit-based business entities differ in terms of *ownership* and *control* (you do not have to run a business simply because you own it), how they raise finance and how the profits are distributed. The four main types of profit-based organizations are sole traders, partnerships, privately held companies and publicly held companies.

(i) Sole traders

A **sole trader** (or **sole proprietor**) is an individual who owns his/her personal business. The owner runs and controls the business and is the only person held responsible for its success or failure. It is the most common type of business ownership across the world. Examples include self-employed decorators, plumbers, mechanics, restaurateurs, private tutors and freelance photographers.

Sole traders may choose to work alone or they might employ other people to help run the business. Sole proprietorships are often small family-run businesses and can be set up with a relatively small amount of capital. Start-up capital is usually obtained from personal savings and borrowing.



Figure 2.2 - A sole trader is a business entity owned by a single person

An important legal point about sole traders is that the business is **unincorporated**. This means the *owner* is the same legal entity as the *business* itself. As there is no legal difference between the business entity and the owner, the sole trader could lose his/her personal possessions if the business collapses (as the owner is personally responsible and liable for all the debts of the business).

Many well-known companies started as sole traders. For example, Chanel (The House of Chanel) was started by Coco Chanel in 1910 and has a huge global presence today. Marks & Spencer was set up in 1904 by partners Michael Marks and Thomas Spencer (who originally operated as sole traders). Multinational retailer Tesco was started in 1919 as a sole proprietorship by Jack Cohen. In 1945, Sam Walton started his business with personal savings of $5,000 and a $20,000 loan from his father-in-law and went on to establish Walmart as the world's largest retailer.

Case study 2.2 - eBay

The eBay concept was created in 1995 by entrepreneur Pierre Omidyar in response to difficulties his fiancée encountered when she was trying to sell collectibles such as PEZ candy dispensers. Omidyar started a sole proprietorship, using a prototype called Auction Web, to sell these and other goods to a growing online community. Three years later, in 1998, eBay became a publicly held company, making Omidyar a billionaire at the age of 31.

Table 2.1 - The advantages and disadvantages of sole proprietorships

Advantages of sole proprietorships	Disadvantages of sole proprietorships
Few legal formalities - Sole traders are quite easy to set up and start-up costs are usually much lower in comparison to starting other types of business entities.	**Unlimited liability** - As an unincorporated business, there is no limit to the amount of debts that a sole trader is legally responsible for if the business fails.
Profit taking - The sole trader is the only owner and therefore receives all of any profits earned by the business. This gives the sole trader an incentive to work hard and to become successful.	**Limited sources of finance** - Sole traders often find it difficult to secure funds beyond personal savings. Growth can also be problematic due to the lack of sources of finance available to sole traders.
Being your own boss - Sole traders do not take orders from anyone, have flexibility in decision-making (such as dictating their own working hours) and self-esteem from being successful.	**High risks** - Statistically, sole proprietorships have the largest risk of failure. The presence of larger and more established firms creates a huge threat to the profits and survival of smaller businesses.
Personalised service - Sole traders can provide a personalised service to customers. Larger businesses might not have the time to get to know all their customers, so their services often become generic and impersonal.	**Workload and stress** - Owners often have to do their own accounts, marketing and human resource management. The sole trader is unlikely to be equally effective in these different roles, so there is added workload and stress.
Privacy - Unlike other types of business entities, sole traders enjoy privacy as they do not have to make their financial records available to the general public, i.e. the owner enjoys confidentiality (although the accounts can be scrutinised by the relevant tax authorities).	**Limited economies of scale** - A sole trader is not able to exploit the benefits of large-scale production, so their prices might be less competitive compared with those of larger rivals. This tends to reduce the competitiveness and profits for the sole proprietor.
Quicker decision-making - There are no other owners to consult, so sole traders can make decisions quickly and independently based on their own needs and preferences.	**Lack of continuity** - The running of the business can be jeopardised if the owner is not present. If the owner decides to go on holiday or becomes ill, the business might have problems in continuing.

Question 2.2 - Flowers by Cam

Cam Tran is a **sole trader** who operates a small florist shop called Flowers by Cam in Montpellier, France. She arranges and delivers flowers to local hospitals, hotels and schools in the local area. At times, she receives large orders for weddings and funerals. She is also busy as a single mother of two school-aged children.



(a) Define the term *sole trader.* *[4 marks]*

(b) Examine the costs and benefits to Cam Tran operating her business as a sole trader. *[6 marks]*

(ii) Partnerships

A **partnership** is a for-profit private sector business owned by two or more persons. For **ordinary partnerships**, the maximum number of owners is 20 (although this can vary from one country to another). The few exceptions to this rule include professions such as solicitors and accountants where issuing shares is prohibited.

Like sole traders, partnerships are financed mainly from the personal funds of each owner. However, partners can pool their funds together to raise more finance than sole traders. They can also raise money from owners who do not actively take part in the running of the partnership but have a financial stake in it. These investors are called **silent partners** (or **sleeping partners**) and are eligible for a portion of any profits earned by the partnership. At least one owner must have unlimited liability, as partnerships are unincorporated businesses, but typically all partners share this liability.

Although it is not a legal requirement, most partnerships create a formal legal agreement between each of the partners. Without a contract, profits or losses must be shared equally amongst the partners who have the same rights in the running of the business.

If a legal contract is drawn up, known as a **deed of partnership** (or **partnership deed**), then it is likely to include:

- The amount of finance contributed by each partner
- The roles, obligations and responsibilities of each partner
- How profits or losses are to be shared between the partners
- Conditions for introducing new partners
- Clauses for the withdrawal of a partner
- Procedures for ending the partnership.



Figure 2.3 - Partnerships consist of two or more owners

Table 2.2 - The advantages and disadvantages of partnerships

Advantages of partnerships	Disadvantages of partnerships
Financial strength - Partnerships have more financial strength than sole proprietorships as there are more owners who can invest in the business, yet they are still fairly easy to set up. In general, it is also easier for partnerships to secure external sources of finance due to the lower risks.	**Unlimited liability** - Legally, partnerships are responsible for their debts 'wholly or severally' meaning the debts can be repaid by either one partner (wholly) or shared among the partners (severally). The rare exception is with *limited liability partners* who have been elected to have limited liability.
Specialisation and division of labour - Unlike sole traders, partners can benefit from shared expertise, shared workload and moral support. For example, a law firm might have partners who specialise in corporate law, divorce law and criminal law. As a result, its client base is likely to be much larger.	**A lack of continuity** - Problems may exist if a partner leaves the firm or passes away because the partnership deed becomes invalid, i.e. it has to be set up again. It is possible to accommodate some changes in a deed of partnership, although solicitors will need to spend time (and money) on drafting the new contract.
Financial privacy - Like sole proprietorships, partnerships do not have to publicise their financial records. Therefore, they can enjoy a fair degree of financial privacy.	**Prolonged decision-making** - In comparison to sole traders, decision-making is likely to take longer as there are more owners involved. Disagreements and conflict might also occur.
Cost-effectiveness - Partnerships can be more cost-effective than sole traders as each partner specializes in certain aspects of their business, thus raising labour productivity and operational efficiency.	**Lack of harmony** - Disagreements and conflict within partnerships is common, but there must also be mutual trust. Each partner is legally and financially accountable to all others, so a mistake made by one person can reduce the profits for every partner.

Unlimited liability exists to prevent sole traders and partners from making careless and irresponsible decisions in managing their businesses. It makes private individuals accountable for their actions and decisions. However, the risk of loss of private property and personal possessions can deter sole traders and partners from taking risks, choosing to make safe decisions instead.

Question 2.3 - EXP

EXP is a small Chinese restaurant with take-away service located in London. It was established in 2016 by partners Keith and Tonina Hoang. EXP is run as a **partnership** with each partner having 50% of the stake in the business. They have a workforce of 12 people, including chefs, counter staff and delivery crew. EXP relies heavily on local customers but faces competition from nearby pizza outlets and Indian and Italian restaurants.

EXP's popularity has grown with a loyal customer base. Keith and Tonina had to discontinue with the distribution of take-away menus in the local area as EXP is already operating near full capacity. Keith and Tonina thought it best to maintain the quality of their food and the punctuality of their home deliveries to maintain the reputation that they have established.

(a) Define the term *partnership* in the context of business entities. *[2 marks]*

(b) Explain **two** advantages of running EXP as a partnership. *[4 marks]*

(c) Discuss the costs and benefits of EXP remaining as a small business. *[10 marks]*

CORE

(iii) Privately held companies

Companies are businesses owned by their shareholders. Shareholders are individuals or other businesses that have invested money to provide share capital for a company or corporation. Corporations are sometimes called **joint-stock companies** because the shares of the business (or 'stock' as they are sometimes known) are jointly held by numerous entities.

Companies are *incorporated* businesses, i.e. there is a legal difference between the owners of the company (the shareholders) and the business itself. The company, being a separate legal entity, has its own legal rights and duties. For example, the company, rather than the owners, would take those who infringe copyright and patent laws to court. It also means that companies have **limited liability** - shareholders do not stand to lose personal belongings if the company goes into bankruptcy or liquidation (see Chapter 19). The maximum a shareholder can lose is the value of his/her investment in the company. This is to safeguard investors - imagine an ordinary individual having to share the debts of a large multinational company that s/he had invested in!

Setting up a company can be complicated and expensive, e.g. there are rules and regulations that must be obeyed for shares to be sold on the **stock exchange**. A stock exchange is a marketplace for trading stocks and shares of publicly held companies (or public limited companies). Examples include the London Stock Exchange (LSE) and the New York Stock Exchange (NYSE).

One reason for such legislation is to protect investors who buy shares in businesses that they do not run or control. A **Board of Directors** (BOD) is elected by shareholders to run the company on their behalf. Directors are elected because of their skills and expertise and because shareholders do not necessarily want to get involved in the daily running of the company. The BOD is held responsible for the running of the company but is held accountable to the shareholders. In most cases, each share held equals one vote, so the more shares held by an investor the more voting power they have. In reality, individual shareholders tend to have very little say as it is the large institutional investors and directors who hold the majority of the shares in a limited liability company.

Exam tip !

Students often use the words 'business' and 'company' interchangeably. Whilst this can be true, it is important to remember that 'companies' are owned by shareholders, so there can only be two types of companies: privately held companies and publicly held companies. The term 'business' also includes other forms of business entities, such as sole traders and partnerships. In summary then, all companies are businesses but not all businesses are companies.

There are two types of limited liability companies – privately held companies and publicly held companies.

A **privately held company** (or **privately owned company**) is a limited liability company that cannot raise share capital from the general public via a Stock Exchange. Instead, shares are sold to private family members and friends. The shares cannot be bought or sold without the prior agreement from the BOD, so that the directors can maintain overall control of the company.

Box 2.1 - Ten examples of privately held companies

- Aldi - Discount supermarket (Germany)
- Chanel - Fashion and Cosmetics (France)
- Ernst & Young - Accounting (USA)
- Huawei - Consumer electronics and technologies (China)
- IKEA - Home furnishing (Sweden)
- LEGO - Toys (Denmark)
- Mars Inc. - Confectionary (USA)
- Rolex - Prestigious wristwatches (Switzerland)
- PriceWaterhouse Coopers - Accounting (USA)
- Virgin Group - Global conglomerate (UK)

For this reason, many privately held companies are run as family businesses. The business will usually have the word 'Limited' or the letters 'Ltd.' after its name. However, this practice varies from one country to another.

All companies must hold an **Annual General Meeting** (AGM) to allow the owners to have a say (or vote) in the running of the business. There are three main processes at a typical AGM:

- Shareholders vote on *resolutions* (promises or declarations) and the re-election (or sometimes election) of the Board of Directors.
- Shareholders ask questions to the Chief Executive Officer (CEO), Directors and the Chairperson about various aspects of the company.
- Shareholders approve the previous year's financial accounts after the Directors present the annual report containing information about its financial performance.



Figure 2.4 - Companies must hold an AGM for their shareholder

Table 2.3 - The advantages and disadvantages of limited liability companies

Advantages	Disadvantages
Raising finance - Companies can raise large amounts of capital by selling shares. There are no interest charges and shareholders are paid dividends only if the company earns a profit.	**Communication problems** - Quite often, as a company becomes larger, services and relationships can become more impersonal to both customers and employees.
Limited liability - As all companies have limited liability, it is easier to attract investors as the risks are relatively low for them.	**Added complexities** - Running a sole-proprietorship or partnership is cheaper and less bureaucratic than running a limited liability company.
Continuity - Unlike partnerships and sole traders, the legal difference between the company and its owners means it can continue to operate as a separate legal entity, even with a change of owners.	**Compliance costs** - Complying with the rules and regulations of being a company add to its running costs. This is particularly the case for publicly held companies due to stock exchange rules and regulations.
Economies of scale - Due to their larger size, companies can benefit from economies of scale (lower unit costs of production as the firms grow). For example, it is usually cheaper for a company to borrow money than it is for sole traders or partnerships as limited companies are less of a financial risk.	**Disclosure of information** - Financial data must be provided to all shareholders. This can be a time consuming and expensive task as auditors have to be hired and Annual Reports have to be published and distributed. Privacy no longer exists, in comparison to that enjoyed by sole traders and partners.
Productivity - Companies can hire directors and specialist managers to run the firm as there is no need for the owners to be directly involved in the daily running of the business. They are also more likely to employ specialist staff such as marketers, lawyers and accountants. Therefore, the output and productivity levels of limited liability companies are generally higher than found in sole proprietorships and partnerships.	**Bureaucracy** - There is far more bureaucracy involved in setting up and running a company, e.g. in the UK, the Companies Act 2006 states that a minimum of £50,000 ($70,000) must be issued as share capital. Solicitors must be hired to ensure that all documents are legally accurate. Advertising and promoting the company's initial public offering (IPO) adds to the costs. Hosting the AGM is also expensive.
Tax benefits - Sole traders and partnerships pay *income tax* on their profits. By contrast, companies pay *corporation tax* on their profits. The highest income tax rate tends to be greater than the rate for corporation tax. Companies also benefit from a wider range of allowances and tax-deductible costs.	**Loss of control** - Whilst sole traders and partnerships retain control of their businesses, publicly held companies face the potential threat of a takeover by a rival company that purchases a majority stake in the business (as shares are openly available for purchase on a public stock exchange).

Before limited liability companies can begin trading, two documents must be produced and submitted to the appropriate authorities:

- The **Memorandum of Association** - a relatively brief document outlining the fundamental details of the company, such as its trading name, its main purpose, the registered business address and the amount of share capital invested.
- The **Articles of Association** (or **Articles of Incorporation**) - the longer of the two documents, stipulating the internal regulations and procedures of the company, such as the rights, roles and power of the BOD and shareholders. Administrative issues are also covered, such as procedures of the Annual General Meeting (AGM), the processes for the appointment of directors and how profits will be distributed.

Once the authorities are satisfied with the above documents and an application fee has been paid, a **Certificate of Incorporation** is issued to the company. This license recognises the business as a separate legal entity from its owners (shareholders) and allows the business to start trading as a limited liability company.

Question 2.4 - Mars Inc.

Mars is a global confectionery and food processing manufacturer with annual sales in excess of $37bn. Perhaps more surprisingly and unusual for a business of this size, Mars is entirely owned by the Mars family, as a **privately held company** - making it one of the largest family-owned businesses in the world. the company employs more than 130,000 people.

The company started with Franklin Clarence Mars (1883-1934) back in 1911 when he and his wife Ethel started making and selling a variety of butter-cream candies in their home in Washington, USA. In 1920, Frank and his son Forrest Edward Mars produced the *Milky Way* bar - known in Europe and other parts of the world as the 'Mars bar'. It was an immediate success.

Today, the portfolio of Mars brands includes Snickers, Wrigley, M&M's and Twix. Having diversified into pet foods, its brands also include Pedigree, Whiskas, Cesar and Sheba. Mars brands are recognised and used in almost every country on the planet.

Source: adapted from Mars website (www.mars.com

(a) Define the term *privately held company*. *[2 marks]*

(b) Discuss the decision of the Mars family to keep their business as a privately held company. *[10 marks]*

Publicly held companies

Whilst a **publicly held company** shares many similarities with a privately held company, it is able to advertise and sell its shares to the general public via a Stock Exchange. It often carries the letters 'PLC' after its name, but again this practice varies between regions (see Box 2.2). Box 2.3 shows examples of publicly held companies.

Box 2.2 - Abbreviations for publicly held companies

- Australia — Pty. Ltd. (short for 'proprietary limited company')
- Germany — AG (short for 'AktienGesellschaft' meaning 'shareholder corporation')
- Nigeria — Ltd. (short for 'private limited company')
- Sweden — AB (short for 'Aktie Bolag' meaning 'limited liability company')
- UK — PLC (short for 'public limited company')
- USA — Inc. or Corp. (short for 'incorporated' or 'corporation')

Flotation is the term used to describe when a publicly held company first sells all or part of its business to external investors (shareholders). This process is known as an **initial public offering** (IPO). The IPO makes the publicly held company *listed* (or registered) on a public stock exchange. Flotation helps to generate additional sources of finance for the company. For example, the Agricultural Bank of China raised $22.1 billion in proceeds from its IPO in 2010, the second-largest IPO of all time. The second largest IPO took place in 2014 when Alibaba Group raised $25 billion on the New York Stock Exchange (NYSE). In 2019, Saudi Aramco broke the IPO record by raising $25.6 billion on the Tadāwul Saudi Stock Exchange.



Figure 2.5 - The NYSE is on Wall Street, Lower Manhattan in New York City

Box 2.3 - Ten examples of publicly held companies

- Apple - Technology (USA)
- Coca-Cola Company - Beverages (USA)
- HSBC - Banking (UK and Hong Kong SAR)
- Michelin - Tyre manufacturer (France)
- MTN Group - Mobile telecommunications (South Africa)
- Nike, Inc. - Sportswear and sports equipment (USA)
- Philips - Electronics conglomerate (Netherlands)
- Samsung - Electronics (South Korea)
- Vodafone - Telecommunications (UK)
- Volkswagen Group - Automobiles (Germany)

Case study 2.3 - Google



On 19th August 2004 Google Inc. floated on the NASDAQ stock exchange following its flotation, thereby becoming a public limited company and raising $2.7bn in the IPO. The shares floated at $85 each but had reached over $600 by 2014 (an increase of over 605% in ten years). By November 2021, Google's share price hit a(nother) peak of $3,037 which represents a rise of 3,473% since its IPO.

The largest shareholders of publicly held companies tend to be institutional and commercial investors, i.e. companies have shares in other companies. For example, Porsche is the majority shareholder of German automaker Volkswagen, which in turn owns a majority of the shares in Audi, Bentley, Bugatti, Lamborghini, SEAT and Skoda.

Nevertheless, shareholders of companies face potential risks, despite their liability being limited. Unprofitable companies cannot distribute any dividends. The share price is likely to fall as a result, causing negative capital growth. Shareholders also place their trust in the Board of Directors and senior management team to run the company on their behalf, although the interest of directors, managers and shareholders might conflict (see Chapter 4). For example, managers and directors might decide to improve pay and conditions to address concerns from the workforce, but this could reduce the amount of funds available for dividends paid to shareholders.

Common mistake

It is incorrect to state that privately held companies are smaller than publicly held companies because this is not necessarily the case. IKEA, LEGO, Huawei, PricewaterhouseCoopers and Mars are all market leaders in their respective industries.

Business Management Toolkit (HL only)

Discuss how the use of Porter's generic strategies (see Chapter 53) can support strategic decision-making in private sector business organizations.

For-profit social enterprises (AO3)

The main features of the following types of for-profit social enterprises: (i) private sector companies, (ii) public sector companies and (iii) cooperatives.

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Social enterprises are revenue-generating businesses with social objectives at the core of their operations. Whilst commercial for-profit businesses strive to return a profit for their owners, for-profit social enterprises strive to return a surplus for social gain rather than personal gain.

Social enterprises can be operated as a non-profit organization or as a for-profit company. Either way, all social enterprises have two main goals:

1. To achieve social objectives and

2. To earn revenues in excess of their costs.

After all, social entrepreneurs (those who use businesses to solve social issues) cannot deliver the social good they desire if they do not manage the financial health of their business. Their success in helping others depends on their ability to operate as a sustainable business, i.e. without a surplus or profit, there is no business for the greater good.

Case study 2.4 - Grameen Bank

In 1983, social entrepreneur Muhammad Yunus established the Grameen Bank in Dhaka, Bangladesh. Grameen Bank, often referred to as the 'bank for the poor' was set up to provide small loans (known as microfinance) to those living in poverty so that they would be able to become financially self-sufficient. Instead of operating like commercial banks, the Grameen Bank does not require any collateral (financial security) from its borrowers.

According to its website (https://grameenbank.org/), over 97 percent of borrowers are women. The Grameen Bank has assets in excess of $2.8bn and employs more than 20,000 workers. Its success as a social enterprise meant that Dr. Muhammad Yunus received the Nobel Peace Prize in 2006 and the Presidential Medal of Freedom award bestowed by US President Barack Obama in 2009.

The main benefits of social enterprises are:

- They use any financial surplus to benefit others in society, beyond personal rewards for shareholders and owners.
- They create employment opportunities, thereby improving the economic and social landscape of local communities.
- They are run in a transparent way, providing tangible benefits in addition to having a clean corporate conscience in the strive to achieve its social mission.
- There are three main types of for-profit social enterprises: (i) private sector companies, (ii) public sector companies and (iii) cooperatives.

(i) Private sector companies

Private sector for-profit social enterprises operate in a similar way to traditional for-profit businesses, but it is what these organizations do with their profits or financial surplus that sets them apart. For-profit social enterprises reinvest or donate any surplus to create positive social change. Furthermore, private sector for-profit social enterprises use ethical business practises to achieve their social aims related to the needs of local communities and societies.

This means that such private sector companies earn their revenues and financial surpluses in socially responsible ways. To benefit the society, a social business organization conducts activities related to the society. Unlike charities that rely on donations, private sector for-profit social enterprises need to earn a financial surplus in order to survive and operate as a sustainable business. Earning a financial surplus is also important to enable these social enterprises to expand their business activities and outreach programmes.

Private sector for-profit social enterprises produce goods or provide services in the same way as for-profit commercial organizations. They can also be established as different legal entities that operate in the private sector, such as private or publicly held companies or as cooperatives. They also compete with other businesses that operate in the same market.

Both private and public sector for-profit social enterprises have three broad aims, commonly referred to as the triple bottom line. The triple bottom line is an accounting framework coined by John Elkington in 1994, consisting of:

1. *Economic aims* – to earn a profit (or surplus) and to reinvest this surplus back in the business for societal benefits.

2. *Social aims* – to provide benefits to people in society, such as jobs opportunities in the local community and to support less-advantaged members of society.

3. *Environmental aims* – to protect the planet, by operating in environmentally friendly and sustainably responsible ways.

(ii) Public sector companies

Public sector for-profit social enterprises are state-owned enterprises run in a commercial way. They are formed by the government through legal means and regulated as they participate in commercial business activities for financial gain. These public sector companies are owned by the government, whether wholly or partially. They help to raise much-needed government revenues yet provide essential services that may be inefficient and undesirable if left solely to the private sector. Examples of such business entities include some national airline carriers, airport authorities, transport operators, telecommunications companies and operators of postal services.

Examples of public sector companies run as for-profit social enterprises include:

- Australia Post is the Australian government's business entity that provides postal services, with over 4,330 outlets throughout Australia.
- Egyptian National Railways (ENR) is the national railway of Egypt, operated by the state-owned enterprise Egyptian Railway Authority.
- Ontario Niagara Parks Commission manages the Canadian side of Niagara Falls, with focus on reformed land use and sustainable tourism.
- Televisión Nacional de Chile (TVN) is the leading Chilean public service television broadcaster, founded in 1969.
- Temasek Holdings is a Singaporean state-owned enterprise that owns 56% of the shares in Singapore Airlines.

Case study 2.5 - China Mobile

China Mobile is the world's largest mobile phone operator with over 945.5 million subscribers. Founded in 1997, China Mobile is a state-owned public sector company, with the Government of the People's Republic of China owning 74.25% share of the company. China Mobile is listed on both the New York Stock Exchange and the Hong Kong Stock Exchange, with the government of the People's Republic of China holds over 74% of the publicly traded shares.

Question 2.5 - Hong Kong Disneyland (HKDL)

Hong Kong Disneyland (HKDL) is a theme park with three on-site hotels. The theme park is jointly owned by the Hong Kong Special Administrative Region of the People's Republic of China (the majority **shareholder**) and the Walt Disney Company. HKDL opened on 12th September 2005, having created 36,000 jobs. It is the smallest of all Disneyland theme parks in the world. HKDL did not earn a profit until 2012, declaring a net profit of HK$109m ($13.97m). Analysts estimated that the theme park would generate HK$148bn ($19bn) in net benefits to the economy over a 40-year period as the **public sector company** continues to expand its operations in Hong Kong.

(a) (i) Define the term *shareholder*. *[2 marks]*

(ii) Define the term *public sector company*. *[2 marks]*

(b) Discuss the decision of the Hong Kong Special Administrative Region of the People's Republic of China to expand HKDL as a public sector company. *[10 marks]*

Common mistake

Do not confuse a publicly held company with a public corporation. The former is a limited liability company that operates in the private sector but offers its shares to the general public on a stock exchange. The latter is owned and operated by the government on behalf of the general public or society as a whole.

(iii) Cooperatives

Cooperatives are for-profit social enterprises owned and run by their members, such as employees or customers, with the common goal of creating value for their members by operating in a socially responsible way. All employees (member of the cooperative) have a vote, thus contribute to decision-making. Cooperatives share any profits earned between their members.

Cooperatives operate in various industries, including retailing, financial services, childcare services, housing associations and agriculture (see Box 2.4). Canada, for example, has over 9,000 cooperatives with more than 18 million members and employ more than 150,000 people (www.cooperativedifference.coop/co-operatives-in-canada/). The UK's Cooperative Group is the world's largest consumer-owned business with over 4.5 million members. There are three main types of cooperatives, all of which are democratically owned and controlled:

- **Consumer cooperatives** are owned by the customers who buy the goods and/or services from cooperatives for personal use. Examples include food, credit unions (financial services), childcare, housing and healthcare cooperatives. In most cases, members get access to goods and services at lower prices than those charged by traditional commercial businesses.

- **Worker cooperatives** are set up, owned and organised by their employee members. Examples include cooperatives involved in production and manufacturing, printers, cafés, tourism and communications. By operating as an enterprise, members are also provided with work opportunities.

- **Producer cooperatives** are cooperatives that join and support each other to process and/or market their products. For example, a farmer cooperative might unite to buy equipment, fertilizers and seeds collectively, by pooling their funds. This enables all members to benefit from bulk purchase discounts. Farmer cooperatives are the most common example of producer cooperatives.

Box 2.4 - Examples of cooperatives

- Associated Press - a non-profit multinational news agency headquartered in the USA.
- Aurora Wine Cooperative - a producer cooperative in Brazil.
- Co-operative Bank - a British commercial bank, founded in 1872, with assets of £25.6 billion ($35.8bn).
- Crédit Agricole Group - one of France's largest banks and credit unions.
- Mondragon Corporation - a Spanish worker-cooperative that produces food and industrial products.
- Ocean Spray - a farmer-based cooperative of the popular cranberry and grapefruit juice drinks.
- Sunkist - US farmer-based producer cooperative that makes the famous Sunkist brand of fruit juices.
- Xinjiang Quanliang - a cooperative founded in 1980 for dairy farmers in China, with more than 2.6 million farmer members.

ATL Activity 2.1 (Research and Thinking skills)

Cooperatives operate under the guidelines and principles of the International Cooperative Alliance (ICA), founded in 1895. Investigate the role of the ICA (http://ica.coop/) and how it supports the cooperative movement around the world.

Table 2.4 - The advantages and disadvantages of cooperatives

Advantages of cooperatives	Disadvantages of cooperatives
Incentives to work - Employees have a stake in the cooperative so are more interested in how it performs. This can enhance staff motivation and productivity.	**Disincentive effects** - There might be ineffective managers and employees as cooperatives do not pay high salaries and bonuses as incentives to work.
Decision-making power - Employees have a say in how the business is run. There is a democratic system of members having equal voting rights. This can also improve the members' commitment and employee loyalty.	**Limited sources of finance** - Cooperatives might suffer from a lack of finance as most of them cannot raise funds through a stock exchange. Sources of finance are often limited to the amount contributed by their members.
Social benefits - Cooperatives are run on socially responsible principles leading to gains for other members of society rather than only for the owners. Thus, cooperatives create social gains that can be enjoyed by the wider community.	**Slower decision-making** - Decisions are likely to be slowed down (delayed) as all members of the cooperative work in a democratic way and are involved in the decision-making process. Every member has a voice in the organization.
Public support - A key advantage of social enterprises such as cooperatives is that there tends to be public support, i.e. people (including customers) want to help them succeed because they believe in the cause the cooperative stands for.	**Limited promotional opportunities** - Cooperatives tend to have flatter organizational structures (see Chapter 8), so there are fewer opportunities for employees to progress in their professional careers.

Note: As cooperatives operate in the private sector, they are an example of private sector for-profit social enterprises.

CORE

ATL Activity 2.2 (Research and Thinking skills)

Investigate the various types of for-profit social enterprises such as co-operatives in your country. Choose one organization and research its mission and objectives and how it operates. Be prepared to share your findings with the rest of the class.

Non-profit social enterprises (AO3)

The main features of the following types of non-profit social enterprises: non-governmental organizations (NGOs)

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Non-profit social enterprises are businesses run in a commercial-like manner but without profit being the main goal. Instead, non-profit organizations use their surplus revenues to achieve their social goals rather than distributing the surplus as dividends to its shareholders or owners. As former British Prime Minister Sir Winston Churchill (1874 - 1965) said, "*We make a living by what we get, but we make a life by what we give.*"

Examples include public libraries, state schools, museums, government hospitals and social services. Well-known non-profit social enterprises include Habitat for Humanity, Oxfam, the Red Cross and the World Wide Fund for Nature. The main type of non-profit social enterprises is non-governmental organizations (NGOs), including international charitable organizations.



Figure 2.6 - NGOs strive to make the world a better place

Exam tip !

The term 'non-profit organization' does not mean that the business does not strive to earn a profit or surplus but that this money must be retained in the organization for its self-preservation and growth. *Profit* is the reward that is distributed to the owners or investors of a business in return for risking their money in the business. By contrast, non-profit organizations (NPO) retain this surplus in the business. For example, many private fee-paying schools are NPOs because any surplus that they make is reinvested in the schools to enhance their facilities and improve teaching and learning.

Non-governmental organizations (NGOs)

The United Nations (UN) defines **non-governmental organizations** (NGOs) as "private organizations that pursue activities to relieve suffering, promote the interest of the poor, protect the environment, provide basic social services or undertake community development". They are private sector not-for-profit social enterprises that operate for the benefit of others rather than primarily aiming to earn a profit. Examples include Médecins Sans Frontières (Doctors Without Borders) and Friends of the Earth.

The term 'non-governmental organization' was coined in Article 71 of the UN Charter that was formed in 1945. An NGO, sometimes referred to as a **private voluntary organization** (PVO), can be any kind of organization so long as:

1. it is independent of the government or direct public sector influence and

2. it is not-for-profit.

Many NGOs are very large organizations, such as Oxfam (global poverty alleviation), Greenpeace (environmental protection), Amnesty International (human rights) and the United Nations International Children's Fund or UNICEF (children's welfare). They are run by a group of senior managers and trustees, similar to a limited liability company's board of directors.

There are two main types of NGOs:

- **Operational NGOs** are established from a given objective or purpose. These NGOs tend to be involved in relief-based and community projects, such as Oxfam and UNICEF.

- **Advocacy NGOs** take a more aggressive approach to promote or defend a particular cause, striving to raise awareness and support through direct action (such as lobbying, public relations and mass demonstrations), such as Greenpeace and Amnesty International.

Case study 2.6 - The Bill & Melinda Gates Foundation

The Bill & Melinda Gates Foundation was set up in 2000 to enhance healthcare and reduce extreme poverty around the world. It is the largest non-profit private sector social enterprise in the world. The Foundation is controlled by its three trustees (the people at the top of the organization): Bill Gates, Melinda Gates and Warren Buffett - the three most generous philanthropists in the USA. According to CNBC, Bill and Melinda Gates have donated over $50 billion to the Foundation.

Theory of Knowledge (TOK)

Can we 'know' if for-profit organizations do not care about society as much as non-profit social enterprises?

Business Management Toolkit

Examine the impact of changes in the external environment on non-governmental organizations. You may find it useful to refer to Chapter 46 (STEEPLE analysis) before attempting to answer this question.

Types of business entities and the key concepts

There are various factors that affect the strategic choice of business entity, including:

- **Amount of finance** - Sole traders and partnerships need less start-up capital than a publicly held company. A change in the legal status of a business will usually require more finance (see Chapter 14).
- **Size** - The larger and more complex the business operations, the more likely it is to be a limited liability company (corporation). Sole traders, for instance, find it unnecessary or unaffordable to hire a large workforce or to operate a tall hierarchical structure (see Chapter 8).
- **Limited Liability** - The desire to have limited liability, in order to protect the personal possessions of the owners, can affect the choice of legal status of a business entity.
- **Degree of ownership and control** - Those who wish to retain control and ownership of a business may prefer to stay relatively small as sole traders or even as privately held companies.
- **The nature of business activity** - The type and scale of business activity can influence the legal status of an organization, e.g. mainstream aircraft and motor vehicle manufacturers rely on external sources of finance (see Chapter 14), so are likely to be formed as publicly held companies.
- **Change** - As a business grows and evolves (see Chapter 6), it may need additional sources of finance and human resources. Thus, the type of organization and its legal status are likely to change.



Figure 2.7 - Some businesses choose to remain small

Key concept

With reference to an organization of your choice, examine how **change** has influenced its business strategy and choice of legal business entity.

Key concept

Discuss the role of **creativity** in creating **sustainable** competitive advantages for a business organization of your choice.

REVIEW QUESTIONS

1. How does the private sector differ from the public sector?
2. What is a sole trader?
3. What are the advantages and disadvantages of a sole trader as a business entity?
4. What is a partnership?
5. What are the advantages and disadvantages of a partnership as a business entity?
6. What is a privately held company?
7. Why is the concept of limited liability important for owners of a company?
8. What is a publicly held company?
9. How does a privately held company differ from a publicly held company?
10. What are the advantages and disadvantages of limited liability companies as a form of business entity?
11. What are social enterprises?
12. What are the differences between private and public sector for-profit social enterprises?
13. What are cooperatives?
14. What are the advantages and disadvantages of cooperatives as a form of business entity?
15. What is a non-governmental organization (NGO)?

KEY TERMS

Cooperatives are for-profit social enterprises set up, owned and run by their members, who might be employees and/or customers.

A **company** (or **corporation**) refers to a limited liability business that is owned by shareholders. A certificate of incorporation gives the company a separate legal identity from its owners (shareholders).

Deed of partnership is the legal contract signed by the owners of a partnership. The formal deeds specify the name and responsibilities of each partner and their proportion of any profits or losses.

Incorporation means that there is a legal difference between the owners of a company and the business itself. This ensures that the owners are protected by limited liability.

An **initial public offering** (IPO) occurs when a business sells all or part of its business to shareholders on a public stock exchange for the first time. This changes the legal status of the business to a publicly held company.

Limited liability is a restriction on the amount of money that owners of a company can lose if the business goes bankrupt, i.e. shareholders cannot lose more than the amount they invested in the company.

Non-governmental organizations (NGOs) are private sector not-for-profit social enterprises that operate for the benefit of others rather than primarily aiming to earn a profit, such as Oxfam and Friends of the Earth.

Partnerships are a type of private sector business entity owned by 2-20 people (known as partners). They share the responsibilities and burdens of running and owning the business.

The **private sector** is the part of the economy run by private individuals and businesses, rather than by the government, such as sole traders, partnerships, privately held companies and publicly held companies.

A **privately held company** is a business owned by shareholders with limited liability but whose shares cannot be bought by or sold to the general public on a Stock Exchange.

A **publicly held company** is an incorporated limited liability business that allows shareholders to buy and sell shares in the company via a public Stock Exchange.

The **public sector** is the part of the economy controlled by the government. Examples include state healthcare and education services, the emergency services, social housing and national defence.

A **sole trader** is a self-employed person who runs the business on his/her own. This mean s/he has exclusive responsibility for its success (profits) or failure (unlimited liability).

Social enterprises are revenue-generating businesses with social objectives at the core of their operations. They can be for-profit or non-profit business entities, but all profits or surpluses must be reinvested for that social purpose rather than being distributed to shareholders and owners.

A **stock exchange** is a marketplace for trading stocks and shares of publicly held companies (or public limited companies). Examples include the London Stock Exchange (LSE) and the New York Stock Exchange (NYSE).

Unlimited liability is a feature of sole traders and ordinary partnerships who are legally liable or responsible for all monies owed to their creditors, even if this means that they have to sell their personal possessions to pay for their debts.



Figure 2.8 - Sole traders and partnerships have unlimited liability

Chapter 3
Unit 1.3 - Business objectives

"If you are working on something exciting that you really care about, you don't have to be pushed. The vision pulls you."
- Steve Jobs (1955 - 2011), Co-founder and former CEO of Apple

Contents

1.3 Business objectives	
SL/HL content	**Depth of teaching**
Vision statement and mission statement	AO2
Common business objectives including: (i) growth, (ii) profit, (iii) protecting shareholder value and (iv) ethical objectives	AO3
Strategic and tactical objectives	AO3
Corporate social responsibility	AO2

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Vision statements and mission statements (AO2)

Having a *vision* means to have an image of an ideal situation in the future. A **vision statement** therefore outlines an organization's aspirations (where it wants to be) in the distant future. For example, "T*o be the leading sports brand in the world*" is the vision of Adidas, the German sportswear and sports equipment giant. Vision statements typically relate to the attainment of success, i.e. visualisation of what success would look like. Martin Luther King Junior's famous "*I have a Dream*" speech (28th August 1963) shows how having a clear vision can bring about fundamental and inspirational change.

Having a *mission* means to have a clear purpose. A **mission statement** tends to be a simple declaration of the underlying purpose of an organization's existence and its core values. For example, a school might set its mission as "the provision of wide opportunities and achievement for all." Unlike business objectives, the mission statement does not have a distinct time frame and tends to be qualitative rather than quantitative. A well-produced mission statement is clearly defined and realistically achievable. It provides a sense of direction, guides decision-making and unifies all people and corporate cultures within the organization in an attempt to achieve the overall vision.



Figure 3.1 - Adidas is Europe's largest sports apparel company

Although vision and mission statements are quite often confused, they do serve complementary purposes. The main differences are:

- The vision statement addresses the question 'what do we want to become?' whereas the mission statement deals with the question 'what is our business?'
- Vision statements are focused on the very long-term, whereas mission statements can focus on the immediate time period.
- Hence, mission statements are updated more frequently than vision statements.
- Vision statements do not have to be actual targets that must be achieved (this is the purpose of setting mission statements). Instead, vision statements allow people to see what *could* be.
- The mission statement tends to outline the values of the business, i.e. its beliefs and guiding principles that set the framework for how managers and employees operate on a daily basis.
- Mission statements are therefore about what the business does 'each and every day' and why it does this, whereas vision statements are about 'some day' (in the distant future).



Figure 3.2 - Vision enables firms to know their long-term aspirations

Box 3.1 - Purpose and characteristics of mission statements

1. Defines the organization, i.e. what it is
2. Outlines what the organization aspires to be (in line with its vision statement)
3. Emphasises the organization's core values
4. Broad enough to allow for growth and evolution in a creative and sustainable way
5. Distinguishes the organization from others in the market
6. Serves to evaluate current business activities
7. Phrased clearly so that it is understood by all.

ATL Activity 3.1 (Thinking and Communication skills)

The IB's mission states that: "*The International Baccalaureate aims to develop inquiring, knowledgeable and caring young people who help to create a better and more peaceful world through intercultural understanding and respect.*"

In groups of 2 or 3, discuss and reflect on the extent to which the IB Business Management curriculum addresses all aspects of the IB mission statement.

Despite the advantages of having vision and mission statements, there are some limitations. Some critics argue that such statements are no more than a public relations stunt. After all, the ultimate purpose of most businesses, they argue, is to maximize profits and protect shareholder value. Constructing meaningful vision and mission statements can also be very time consuming; it is difficult to draft a statement that caters for all the dynamics of a business and meets the needs of every stakeholder group. Even the best thought-out statements might not be supported by everyone, such as employees on part-time or temporary contracts. In such cases, it can be a lengthy process to convert people's beliefs and behaviour.

ATL Activity 3.2 (Thinking skills)

Reflect on your own school's vision or mission statement. To what extent is it applicable and appealing to all stakeholder groups of the school? To what extent is the vision or mission statement evident in the daily operations of your school?

ATL Activity 3.3 (Research skills)

Investigate the personal mission statements of famous leaders such as Benjamin Franklin, Mahatma Gandhi, Martin Luther King Jr. and Ludwig van Beethoven. Then have a go at reflecting on and/or discovering your personal values to build your own mission statement. A good starting point is FranklinCovey's mission statement builder website (https://msb.franklincovey.com).

Question 3.1 - Vision and mission statements

Examples of organizational vision and mission statements include:

- To be the most successful premium manufacturer in the industry - BMW
- The company exists to benefit and refresh everyone it touches - Coca-Cola
- To organise the world's information and make it universally accessible and useful - Google
- Creating the finest ice cream - Häagen-Dazs
- Inspire and develop the builders of tomorrow - Lego
- To help people and businesses throughout the world realise their full potential - Microsoft
- A just world without poverty - Oxfam
- To make people happy - Walt Disney Company

Source: Company websites

(a) Define the term **mission statement**. *[2 marks]*

(b) With reference to the above examples, explain the role of vision and mission statements in business organizations. *[4 marks]*

Common business objectives (AO2)

Common business objectives including: (i) growth, (ii) profit, (iii) protecting shareholder value and (iv) ethical objectives. AO3

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Objectives are the goals or targets an organization strives to achieve. They are generally specific and quantifiable (measurable) and are set in line with the organization's mission statement. Without having clear business objectives, organizations have no real sense of direction or purpose. It is rather like getting into a taxi and not knowing where you want to go! Organizational objectives are important for three reasons:

- To *measure and control* – Business objectives help to control a firm's plans as they determine the parameters for business activity. Essentially, objectives provide the basis for measuring and controlling the performance of the business as a whole.
- To *motivate* – Business objectives can help to inspire managers and employees to reach a common goal, thus helping to unify and motivate the workforce. They also encourage managers to think strategically, i.e. to plan for the long term success of the business.
- To *direct* – Business objectives provide an agreed and clear focus (or sense of purpose) for all individuals and departments of an organization. As the foundation for decision-making, organizational objectives are used to devise appropriate business strategies.

Common business objectives, as specified in the syllabus, include: (i) growth, (ii) profit, (iii) protecting shareholder value and (iv) ethical objectives.

(i) Growth

The growth of a business is usually measured by an increase in its sales revenues or by its market share (the firm's sales revenue expressed as a percentage of the industry's total sales revenue). Growth is essential for the survival of a business in an ever-changing and competitive world, especially with the exposure of businesses to mergers and takeovers (see Chapter 6). The failure to grow may result in declining competitiveness and threaten the firm's sustainability.



Figure 3.3 - Growth is essential for business survival

(ii) Profit

Traditionally, the main business objective of most private sector organizations is to maximize profits. Profit provides an incentive for entrepreneurs to take risks in setting up and running a business. For incorporated businesses (Chapter 2), a proportion of the profits (called **dividends**) is distributed to their shareholders.

Without a profit motive, owners and investors find it difficult to justify the existence of the business. Milton Friedman (1912 - 2006), recipient of the Nobel Prize in Economics in 1976, said that "*there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits.*"

Key concept

Is it only ever possible for businesses to be profitable if they are **creative** and **ethical**?

(iii) Protecting shareholder value

This business objective is about generating long-term value for shareholders (owners) of the business. Protecting and maximizing shareholder value is about earning a profitable return for shareholders in a sustainable way.

Most shareholders do not typically get involved in the day-to-day operations of the company, so rely on directors, managers and employees to protect their interests. The board of directors is ultimately and directly responsible for protecting and managing shareholders' interests in the company. Shareholder value is the result of the business strategy the board of directors pursues. A challenge for the directors is to balance short-term profits (in the form of dividends) with an investment in the long-term value of the company.



Figure 3.4 - Directors are responsible for protecting shareholder value

Key concept

Discuss why **change** might be essential for businesses to protect shareholder value.

(iv) Ethical objectives

Ethics are the moral principles that guide decision-making and business strategy. They are concerned with what is considered to be right or wrong, from society's point of view. For example, the use of direct marketing techniques aimed at children is banned in many countries as this is deemed to be unethical. The existence of health and safety legislation helps to prevent the exploitation of employees.

Business ethics are therefore the actions organizations that are considered to be morally correct employ. An ethical business acts morally towards its workers, customers, shareholders and the natural environment. For example, an ethical employer would ensure all employees are given sufficient rest breaks

during the day. Examples of ethical objectives that are in line with the use of circular business models (see Chapter 51) include:

- Disposal of waste in an environmentally safe manner.
- Fairer conditions of trade with low-income countries.
- Increased recycling of waste materials.
- Reducing pollution by using more environmentally friendly technologies and production processes.

Box 3.2 - Examples of unethical business behaviour

- *Financial dishonesty* occurs if a business mismanages its finances, such as the deliberate misrepresentation of its financial accounts (which is also illegal). There might also be moral issues, such as extravagant business expenses incurred by the directors (unethical but not illegal).
- *Environmental neglect and damage* often occur as business activity can create harmful consequences to the natural environment, such as environmental pollution and the depletion of non-renewable resources.
- *Exploitation of workers* occurs if employers mistreat employees through the deliberate neglect of their welfare. Many multinational companies have been criticised for the poor pay and working conditions offered to staff in low-income countries, for example.
- *Exploitation of suppliers* happens when large businesses take advantage of their suppliers, forcing them to cut prices. This is controversial, especially when the business is exploiting suppliers in low-income countries or when the savings are not passed onto consumers in terms of lower prices.
- *Exploitation of consumers* takes place if firms knowingly sell products that have harmful side-effects, such as tobacco, alcohol and gambling services. Large firms with few, if any, competitors might abuse their market power by charging customers excessively high prices.

Case study 3.1 - Unethical discrimination

- In 2006, Indian Airlines (now merged with Air India) was heavily criticised by the mass media for grounding female flight attendants for being too overweight to travel. They were told to lose weight or risk losing their jobs.
- In 2010, female workers at Hooters, an American fast-food chain, filed lawsuits against the company of claims of weight discrimination, after at least one worker was placed on weight probation.
- In 2021, the Norwegian women's beach handball team was fined by the European Handball Federation for refusing to play in bikini bottoms (opting instead to wear non-regulation shorts similar to those worn by male athletes) at the European Beach Handball Championships. According to the governing body of the sport, this broke the uniform regulations in the rules of the game.

Case study 3.2 - The ethics of fast food

Faced with negative exposure in best-sellers like Fast Food Nation and movies such as *Super-size Me* (https://goo.gl/mvGa2h), fast-food giant McDonald's responded to public demand for improvements by changing its product portfolio to include fresh salads and other healthier alternatives.

To achieve their ethical objectives, an increasing number of businesses have adopted an **ethical code of practice** and publish this in their annual reports. The code of conduct refers to the documented beliefs and philosophies of the business. It is important because people need to know what is considered acceptable or not acceptable within an organization, such as guidelines and expectations on employee behaviour. These values might differ from one individual to another and from one business to another. Hence, a code of ethics, such as having personal integrity and consideration for others, can provide a framework for consistency and uniformity in the workplace.

Table 3.1 - The advantages and limitations of having ethical objectives and practices

Advantages	Limitations
Improved corporate image - Acting ethically and in a socially responsible way can help to enhance the corporate image and reputation of a business. Conversely, the media will report unethical business behaviour which could seriously damage the firm's corporate image.	*Compliance costs* - The costs of being socially responsible are potentially very high. For example, producing organic agricultural products is far more expensive than growing and harvesting genetically modified crops due to the additional time and money involved.
Increased customer loyalty - Customers are more likely to be loyal to a business that does not act immorally. For example, The Body Shop has established a large customer base worldwide based on its ethical policy of not testing its products on animals.	*Lower profits* - If compliance costs cannot be passed onto consumers in the form of higher prices, the firm's profitability is likely to fall. An ethical dilemma for the business exists when ethical decision-making involves adopting a less profitable course of action.
Cost cutting - Ethical behaviour can help to cut certain costs, e.g. being environmentally friendly can reduce the amount of (excess) packaging. Ethical objectives and strategies can help the firm to avoid *litigation costs* (expenses associated with legal action taken against a business) that might otherwise arise from unethical and irresponsible activities.	*Stakeholder conflict* - Not all stakeholders are keen on the firm adopting ethical objectives, especially if this conflicts with other business objectives such as profit maximization. Speculative shareholders and investors may be more interested in short-term profits than the firm's long-term ethical stance. So, managers may be pressurised into pursuing other goals.
Improved staff morale and motivation - Ethical behaviour can help a business to attract and retain highly motivated staff. People are more likely to be proud of the firm they work for if it acts ethically and within the law. This also helps to improve productivity and employee loyalty.	*The subjective nature of business ethics* - Views about what is considered right or wrong depend on the beliefs and principles held by individuals and societies. Legislation can help to provide guidelines about what is socially acceptable, but even these are somewhat subjective in nature.

ATL Activity 3.4 (Thinking skill)

Scenario: You see a teacher drop her wallet in the school corridor, but the teacher doesn't realise she's done so. There are no other people around. What should you do?



Being principled is one of the aspects of the IB Learner Profile. The answer will depend upon the values or moral principles that you feel are important. These could be determined by numerous situational factors such as:

- Integrity - how honest you are.
- Sympathy - how you feel, if anything, about the teacher losing her wallet.
- Empathy - if you have experienced losing your own valuables, you will have a better understanding of the feelings of the teacher.
- Loyalty - the teacher could be your favourite teacher or someone you really respect.
- Conscience - whether the student has any concerns or feelings of guilt.
- Justice - you might think the teacher is rather careless and should learn the hard way!

Key concept

Discuss the value of **ethical** business objectives.

Key concept

Is it practical for a business to simultaneously protect shareholder value *and* strive to achieve **ethical** objectives?

Theory of Knowledge (TOK)

Using any two concepts from the TOK course, discuss how it is possible to 'know' what is right for managers to do.

ATL Activity 3.5 (Research skills)

Investigate how ethical business behaviour can improve the corporate image of a business **and** strengthen customer loyalty. Be prepared to share your findings with the rest of the class.

Business Management Toolkit (HL only)

Discuss how the use of force field analysis (see Chapter 55) can help managers and decision makers to determine their priorities and business objectives.

Strategic and tactical objectives (AO3)

Strategies are the medium to long-term plans of action to achieve the *strategic objectives* of an organization. **Tactics** are short-term methods used to achieve an organization's *tactical objectives*. Both strategy and tactics serve matching purposes, i.e. how a business intends to get to where it wants to be. Once a business has decided on its short- and long-term goals, it can then decide on the most suitable methods to achieve these targets.

Tactical objectives are short-term goals that affect a section of the organization. They are specific goals that guide the daily functioning of certain departments or operations, such as to raise sales revenue of a certain product line by $10m within the next year or to keep staff turnover below 10%. Tactical objectives tend to refer to targets set for the next 12 months or sooner. Such objectives might include:

- **Survival** - New and unestablished businesses are likely to encounter a number of problems (see Chapter 2) such as a lack of brand recognition, a small customer base and/or intense rivalry from existing firms. Hence, survival becomes a key tactical objective. Survival can also be important for more established organizations during an economic recession (see Chapter 46). For example, the global financial crisis of 2008 and the COVID-19 pandemic threatened the survival of many businesses across all industries. Alternatively, if a business becomes a takeover target (see Chapter 5), then its survival as it currently exists could easily become the key tactical objective.

- **Sales revenue maximization** - New businesses strive to maximize their sales revenue to establish themselves in the marketplace. Sales staff and agents, such as those selling insurance or real estate, favour this tactical objective as their earnings are linked to the value of sales revenue. However, sales revenue is not the same as profit (the surplus that remains after all costs are paid). In the long-term, a firm with high sales revenue but low or no profit will struggle to survive.

Strategic objectives are the longer-term goals of a business, such as profit maximization and growth explained above. Additional examples of interrelated strategic objectives are outlined below (but note that these vary between businesses, based on their own circumstances and priorities):

- **Market standing** - This refers to the extent to which a business has presence in the industry. For example, Microsoft has high market standing as the market leader in the computer software industry. Walmart has high market standing for being the world's largest retailer. Toyota has market standing as the world's largest car producer. Apple has high market standing due to its innovative products and designs. The Body Shop has high market standing for being a socially responsible business. Having high or good market standing brings competitive advantages for these businesses.

- **Image and reputation** - Businesses may strive to enhance their image and reputation. A bad image, perhaps portrayed by the media, can turn customers against a firm's products and services and tarnish the corporate image of the business. Increasingly, businesses strive to deliver improved levels of customer service, offer better facilities and deliver superior after-sales care. Employees are more likely to be motivated and proud if the business has a positive corporate image. This helps to attract and retain high-calibre employees and managers. Suppliers also prefer to do business with organizations that are reputable and reliable.

- **Market share** - Businesses may strive to increase their market share over time. Market share is measured by expressing the firm's sales revenue as a percentage of the industry's total sales. The higher the firm's market share, the greater its market dominance and ability to compete against rivals in the industry.

In practice, businesses have a combination of strategic objectives, which are subject to change from time to time, such as survival being a key strategic objective if a firm is threatened by a hostile takeover (see Chapter 5). The organizational culture (see Chapter 11) and whether a business operates in the private or public sector (see Chapter 1) are also factors that affect the aims and objectives it sets.

It should be noted that business objectives have the potential to conflict. For example, employees may demand better pay and working conditions which may subsequently reduce profits, at least in the short-term. Nevertheless, in the pursuit of success, managers must base their strategy on achieving the organizational objectives. As American media mogul William Randolph Hearst (1863-1951) said, "*You must keep your mind on the objective, not on the obstacle.*"

CORE

Question 3.2 - Lenovo



Chinese multinational technology company Lenovo acquired the personal computers division of IBM in 2005. Lenovo's goal was to establish itself outside of the Asian market by owning IBM's globally recognized brands such as ThinkPad laptops. Lenovo is committed to four key values:

- Customer service
- Trust and integrity
- Teamwork across cultures
- Innovation and entrepreneurial spirit.

Lenovo strives to increase its market presence by sponsoring key sporting events and teams, such as McLaren, the British Formula One (Grand Prix) Team, the Williams Formula One racing team, the National Basketball Association (NBA) and the 2008 Beijing Olympic Games. In 2012, Lenovo became the official sponsor of the National Football League (NFL), its largest sponsorship in America. Its **strategy** has helped the company to gain **market share** around the world.

Source: adapted from www.lenovo.com

(a) (i) Define the term *strategy.* *[2 marks]*

(ii) Define the term *market share.* *[2 marks]*

(b) Explain why is it important for Lenovo to specify its organizational objectives. *[4 marks]*

(c) Examine the barriers that might prevent Lenovo meeting its objectives. *[6 marks]*

Key concept

To what extent should business objectives incorporate **creativity**?

Theory of Knowledge (TOK)

Some people argue that by targeting children, especially in an era of growing child obesity in many parts of the world, parents face unnecessary pressure to buy their children fast food products. Do you consider McDonald's marketing of its 'Happy Meal' as simply creative or unethical? Justify your answer.

Corporate social responsibility (CSR) (AO3)

Corporate social responsibility (CSR) is the conscientious consideration of ethical and environmental practise related to business activity. A business that adopts CSR acts morally towards all of its various stakeholder groups (see Chapter 4) and the well-being of local communities and society as a whole. For example, McDonald's employees regularly go on litter patrol to collect rubbish (including trash not generated by McDonald's customers) in the vicinity of their restaurants. It also gets involved in local community fund-raising events such as supporting charity runs. Lenovo, China's largest computer maker, commits 1% of its pre-tax income to good causes as part of its CSR policy. During the global COVID-19 pandemic, Eric Yuan (CEO of Zoom) gave away the premium version of Zoom's videoconferencing software to schools, completely free of charge, to help educators and students affected by school closures.



Figure 3.5 - Many businesses support local community events such as charity runs

Box 3.3 - Examples of CSR

- Providing accurate information and labelling - This can help consumers to make more informed decisions. For example, food manufacturers might provide truthful nutritional information.
- Adhering to fair employment practices - Firms can fulfil their corporate social responsibilities to their employees by providing decent working conditions, fair remuneration and training and development opportunities. Conversely, some multinational companies have been criticised for exploiting child labour by hiring under-aged workers in low-income countries.
- Having consideration for the environment - Businesses may seek to use more recycled materials in the production process, recycle a greater proportion of their waste materials and aim to reduce any pollution or environmental damage caused by their activities.
- Active community engagement - This includes voluntary and charity work and other ways to help give something back to society. Examples include sponsoring and participating in local community events.

Media exposure in many countries has meant that large multinational companies are expected to donate part of their profits to charity. Customers are more careful about spending money on products from socially irresponsible firms. Investors are more wary of placing their money with unethical firms, such as those that employ child labour. Through pressure group action and educational awareness, climate change and environmental damage are huge concerns of governments and citizens around the world, so businesses are changing their objectives to reflect their part in the protection of the planet. Businesses that continue to pollute and damage the environment are likely to earn themselves a poor corporate image with devastating consequences. Hence, society's changing perception of what is considered socially moral will directly affect an organization's view of its own corporate social responsibilities and business objectives.



Figure 3.6 - Businesses have a moral obligation to protect the planet

The nature of CSR is rather subjective - what is considered 'right' or 'wrong' is largely based on public opinion. The subjective nature of CSR also means that attitudes may change over time. What was once considered socially acceptable, such as advertising campaigns targeted specifically at young children, may no longer be the case. Environmental protection was not a major issue prior to the 1980s. Some countries do not think it is necessary to impose a national minimum wage, whilst others feel that such regulation prevents some businesses from paying unethically low wages to their employees. The advertising of tobacco products is considered socially immoral in many parts of the world (where advertising of tobacco products is banned), but this is not the case in other countries.

CSR is further complicated when businesses operate in different countries. This is because what might be considered acceptable in one country might be totally undesirable in others. For example, Serbia, Bangladesh and Russia are huge consumers of tobacco, so cigarette advertising is less stringent than in other countries such as the UK and Singapore. Australia and Canada judge environmental concern as a key indicator of CSR, whereas India and China place less emphasis on environmental protection.

Businesses have long realised that a good reputation (how others view the organization) can give them an important competitive advantage. According to *Fortune* magazine, the top 500 American firms donate over 2% of their post-tax profits to charity. This might be due to their goal or desire to act in a socially responsible way, or it could be due to the fear of negative publicity caused by non-compliance. Acting in a socially responsible way can help to improve a firm's reputation, but the compliance costs will add to its expenses. For employees and investors to support the organization to meet its ethical objectives, they must be convinced that CSR is in their best interest too.

Question 3.3 - CSR at McDonald's and Burger King

Ronald McDonald House Charities (RMHC) is a **non-profit organization**, created by McDonald's. The charity's mission statement is to "*directly improve the health and well-being of children*". Operating in 64 countries and regions, RMHC has helped to make a difference to millions of seriously ill children and their families. *Source*: www.rmhc.org

Burger King, the world's second largest fast-food chain and the largest rival of McDonald's, has used humanely sourced meats and eggs since 2007. This means Burger King gives priority and better deals to suppliers that provide cage-free chickens and free-range pigs. Burger King operates two national charitable organizations: the Have It Your Way Foundation (which focuses on hunger alleviation, disease prevention and community education) and the McLamore Foundation (providing scholarships to students since 2000). *Source*: www.bkmclamorefoundation.org

(a) Define the term *non-profit organization*. *[2 marks]*

(b) In the context of the above case studies, explain the meaning of ethical business behaviour. *[4 marks]*

(c) Distinguish between vision and mission statements. *[4 marks]*

(d) Discuss whether acting ethically ultimately provides McDonald's and Burger King with competitive advantages. *[10 marks]*

Key concept

Justify whether protecting shareholder value or corporate social responsibility (CSR) is a more **sustainable** business objective.

Theory of Knowledge (TOK)

Does the lack of awareness and knowledge of ethics allow businesses to neglect their morale obligations as a business entity?

Despite the driving forces for setting ethical objectives, whether a business acts in a socially responsible way depends on several interrelated factors:

- The involvement, influence and power of different stakeholder groups, such as pressure groups and the government.
- The corporate culture and the firm's attitude towards CSR and ethical objectives.
- Societal expectations, i.e. the general public's awareness and concerns for CSR issues.
- Exposure and pressure from the mass media.
- Experience - quite often it takes a crisis (see Chapter 41) or bad experience to precipitate attention to CSR.
- Compliance costs, i.e. the human and financial resources and costs needed to implement CSR policies.
- Laws and regulations, i.e. legislation that govern how firms conduct themselves in a socially responsible way.

ATL Activity 3.6 (Research skills)

Seconds from Disaster: The *Deepwater Horizon* is an excellent documentary that looks at the events of the Deepwater Horizon rig in the Gulf of Mexico. BP's attempts to cut back on safety checks ultimately resulted in the world's largest accidental marine oil spill, costing the company billions of dollars in lost revenues and fines.
Watch the video here: https://bit.ly/3JcaTcL

Question 3.4 - Walmart

Walmart is the world's largest retailer and largest private sector employer in America. The company has, on numerous occasions, been fined millions of dollars by the US government for violating air and water pollution legislation. This obviously harmed the image of the global retailer, with the media alleging that 8% of customers had stopped shopping at Walmart as a result of its neglect of the environment.

Labour unions have criticised Walmart's unethical business practices which have caused **labour turnover** rates of around 70% in some stores. Walmart has also been taken to court for alleged cases of not paying some employees for overtime, forcing them to work without proper rest breaks and discriminating against female workers for pay and promotion.

(a) Define the term *labour turnover.* *[2 marks]*

(b) State **two** possible barriers to a business, such as Walmart, behaving in a corporate socially responsible way. *[2 marks]*

(c) Discuss whether it is morally correct for businesses such as Walmart to put profits before the environment and the welfare of their employees. *[10 marks]*

Theory of Knowledge (TOK)

In reality, is it possible to determine whether CSR is genuine altruism or selfish acts used to improve a firm's corporate image for its personal gain? Does this even matter?

Theory of Knowledge (TOK)

Does the study of Business Management tend to steer people towards ethical or self-centred decision-making? Does this matter?

Business Management Toolkit

Using real-world examples, discuss the role of corporate social responsibility in relation to circular business models (see Chapter 51).

CORE

Business objectives and the key concepts

There are various factors that can cause the objectives of a business to change, requiring creative responses to these factors. Some of the **internal factors** (those within the control of the organization) that can cause a change in business objectives to ensure its strategies are sustainable include:

- *Corporate culture* (the accepted norms and customs of an organization) - Firms with a flexible and adaptable organizational culture are more likely to have creative objectives that change over time.
- *Type and size of organization* (see Chapter 2) - Any change in the legal status of a business entity is likely to cause a change in its objectives. With a separation of ownership and control, such as in the case of publicly held companies, various stakeholder objectives need to be considered, including managerial objectives (such as higher bonuses) and shareholder objectives (such as higher dividend payments from higher profits).
- *Private versus public sector organizations* - Unlike most private sector firms, most public sector organizations (see Chapter 2) do not strive for profit maximization but to provide a service to the general public.
- *Age of the business* - Newly established firms tend to have survival as their key objective, whereas established businesses might strive for growth and higher market share.
- *Finance* - The amount of available finance will determine the scope of a firm's objectives. For example, a huge sum of money is needed if the business objective is to expand into overseas markets.
- *Risk profile* - If managers and entrepreneurs have a relatively high willingness and ability to take risks, then more ambitious objectives are likely to be set, such as diversification strategies to enter new markets with new products (see Chapter 45).
- *Crisis management* - Businesses may face internal crises such as unexpectedly high staff absenteeism and labour turnover rates, falling productivity and motivation problems, liquidity problems (see Chapter 19), or issues about quality standards (see Chapter 37).

External factors (those beyond the control of the organization) can also change the objectives of a business to ensure its strategies are sustainable. These factors include:

- *State of the economy* - The state of the economy (see Chapter 46) can change business objectives. For example, an economic boom (when national income and employment are high) provides many business opportunities whereas a recession (when unemployment is high and consumption is low) can threaten business survival.
- *Government constraints* - Some government rules and regulations can limit creativity and what a business might strive to achieve. For example, environmental protection laws can limit the ability of firms to profit maximise due to the higher costs of compliance.
- *The presence and power of pressure groups* - Pressure groups, such as environmental protection groups, can force a business to review its approach to ethics through their lobbying activities. Pressure groups may harm a company's corporate image if it is not adopting a socially responsible and sustainable approach to conducting business.
- *New technologies* - New technologies and creativity can generate many new business opportunities, thus change

business objectives. Innovative firms such as Samsung were able to exploit digital technologies to dominate the smartphone and smart TV industries. The use of e-commerce technologies has also revolutionised how most businesses operate.



Figure 3.7 - Digital boarding passes provide cost-saving benefits to airlines

A change in any of the above internal or external factors is therefore likely to change an organization's objectives over time. For instance, if a public sector organization is privatized (sold to the public sector), then the business may change its strategic objective from providing an affordable service to one of profit maximization. Therefore, business strategy (the tools used to achieve a firm's objectives) will subsequently change. A change in the strategic direction of a business will automatically require a change in business strategy to achieve its revised objectives. Changes in society's expectations of businesses, such as their ethical practices, will also directly affect their objectives and strategy. Finally, organizations also change their objectives over time simply because the original goals have been achieved so new ones need to be set for a sustainable future.

Exam tip !

Whist there is little, if anything, that a business can do about **changes** in the external environment, successful businesses alter their tactics and strategies to adapt to such changes. Also, remember that positive changes can occur from the external environment, thus creating business opportunities (see Chapter 46).

Theory of Knowledge (TOK)

Is it reasonable for an employee or an organization to be deceitful for the benefit of charity?

Theory of Knowledge (TOK)

Some analysts argue that it is not the role of managers to decide what is right or wrong. This is because managers do not use or risk their own money when making decisions about what they personally believe to be socially responsible. Instead, managers are employed to run a business on behalf of the owners who seek profit, rather than using money in socially responsible ways such as donating money to charity.

How can managers and decision makers know what is the right thing to do?

Key concept

With reference to an organization of your choice, discuss how **creativity** and **change** influence business objectives.

Key concept

Examine the impact of **ethics** on the business objectives of an organization of your choice.

Key concept

How important are corporate social responsibilities (CSR) and ethical business objectives for the **sustainability** and success of a business?

Key concept

For an organization of your choice, examine why business objectives might **change** over time.

REVIEW QUESTIONS

1. How do mission and vision statements differ from one another?
2. Why are objectives important to business organizations?
3. What does it mean for a business to protect shareholder value?
4. What is meant by ethical objectives?
5. How does growth differ from profit as business objectives?
6. How do strategic objectives differ from tactical objectives?
7. What is corporate social responsibility (CSR)?
8. What are the advantages and disadvantages of business acting in a socially responsible way?



Figure 3.8 - Ethics and CSR are important for the long-term success of a business

KEY TERMS

Corporate social responsibility (CSR) is the conscientious consideration of ethical and environmental practice related to business activity. A business that adopts CSR acts morally towards all of its various stakeholder groups and the well-being of society as a whole.

An **ethical code of practice** is the documented beliefs and philosophies of an organization, so that people know what is considered acceptable or not acceptable within the organization.

Ethical objectives are organizational goals based on moral guidelines, determined by the business and/or society, which direct and determine decision-making.

Ethics are the moral principles that guide decision-making and business strategy. Morals are concerned with what is considered to be right or wrong, from society's point of view.

A **mission statement** refers to the declaration of an organization's overall purpose. It forms the foundation for setting the objectives of a business.

Objectives specify what an organization strives to achieve. They are the goals of an organization, such as growth, profit, protecting shareholder value and ethical objectives.

Strategic objectives are the longer-term goals of a business, such as profit maximization, growth, market standing and increased market share.

Strategies are the various plans of action that businesses use to achieve their targets. They are the long-term plans of the organization as a whole.

Tactical objectives are short-term goals that affect a unit of the organization. They are specific goals that guide the daily functioning of certain departments or operations.

Tactics are the short-term plans of action that businesses use to achieve their objectives.

A **vision statement** is an organization's long-term aspirations, i.e. where the business ultimately wants to be.

Chapter 4
Unit 1.4 - Stakeholders

"Knowledge is of no value unless you put it into perspective."
- Anton P. Chekhov (1860 - 1904), Russian playwright

Contents

1.4 Stakeholders	
SL/HL content	**Depth of teaching**
Internal and external stakeholders	AO2
Conflict between stakeholders	AO2

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Internal stakeholders (AO2)

The word 'stake' means to have an interest or to be involved in something. A **stakeholder** is any individual, group or organization with a direct interest or involvement in the operations and performance of a business. Hence, stakeholders are impacted by the activities of the organization. Stakeholders can be categorised as internal or external.

Internal stakeholders are members of the business, namely (i) employees, (ii) managers and directors and (iii) shareholders (owners) of the organization.

(i) Employees

The staff of a business will have a direct stake in the organization they work for. Employees are likely to strive to improve their pay (including other financial benefits), working conditions (such as hours of work and the physical working environment), job security and opportunities for career progression.

Theorists such as Charles Handy (see Chapters 8 and 11) argue that employees are an organization's most valuable asset. It is the staff who produce goods and services for sale; they are the ones who directly communicate with the customers. Consequently, more employers have encouraged their workers to be involved in decision-making. A motivated workforce is more dynamic and loyal. Hence, it is important for businesses to meet the needs of their employees as far as is possible. As American comedian Fred Allen (1894-1956) said, "*Treat employees like partners and they act as partners.*"

British entrepreneur Sir Richard Branson would agree with Charles Handy and Fred Allen. Branson famously declared that he puts his employees first, customers second and shareholders third. He claims that by doing this, both customers and shareholders will benefit. After all, demotivated workers are unlikely to produce good quality products or deliver good customer service (see Chapter 10). Worse, disgruntled staff might take industrial action (see Chapter 13). For example, around 40,000 BMW workers went on a prolonged labour strike at its South Africa car plant in late 2013 causing export sales to fall by 75%. In 2019, a pilots strike at British Airways cost the company lost earnings of €215 million ($245m).

(ii) Managers and directors

Managers are the people who oversee the daily operations of a business. **Directors** are senior executives who have been

elected by the company's shareholders to take charge of business operations on behalf of their owners.

Senior managers and directors might aim to maximize their own benefits, such as annual bonuses and other financial rewards (see Chapter 10). Hence, they are likely to aim for profit maximization (see Chapter 3). This would also please the shareholders, helping to safeguard the jobs of top executives. Moreover, senior staff will look at the long-term financial health of their organization. For example, they might aim to retain profits for further investment in the business.

(iii) Shareholders

Limited liability companies (see Chapter 2) are owned by their **shareholders.** This stakeholder group invests money in a company by purchasing its shares. Shareholders (also known as **stockholders**) are a powerful stakeholder group as they have voting rights and a 'say' in how the company is run.

As the owners of the company, shareholders are entitled to a share of its annual profits. Shareholders have two main interests or objectives:

- To maximise *dividends* (a proportion of the company's profits distributed to shareholders).
- To achieve *capital gain* in the value of the company's shares (a rise in the value of the shares).

Common mistake

Many students confuse the terms *stakeholders* with *shareholders,* treating them as the same thing. Shareholders are the owners of a limited liability company so are only one stakeholder group of the business, albeit an important one.

Exam tip !

Some shareholders are internal stakeholders (such as directors or employees who hold shares in the company) whilst others can be external stakeholders (those who own shares in the company but are not directly involved in the daily operations of the business).

Question 4.1 - Nokia and Microsoft



Nokia was once the pride of Europe having been the market leader in the mobile phones industry from 1998 to 2008, enjoying up to 49.4% **market share**. In 2005, the Finnish company sold its one billionth mobile phone. By 2007, its market value was a staggering $150 billion, making it the 5th most valuable brand in the world.

However, the huge popularity of Apple and Samsung smartphones eventually forced Nokia to be sold to Microsoft for 'just' €5.4 bn ($7.3bn) in November 2013. An overwhelming 99.5% of Nokia's 3,900 shareholders voted in favour of the deal after seeing its share price drop by 93% and its market share continually decline to only 3%. The company's 32,000 employees who worked in the mobile phones division were transferred to Microsoft Mobile in early 2014.

(a) Define the term *market share.* *[2 marks]*

(b) Explain the difference between Nokia's *shareholders* and *stakeholders.* *[4 marks]*

(c) Examine how different stakeholder groups are likely to be affected by Microsoft's takeover of Nokia. *[6 marks]*

External stakeholders (AO2)

External stakeholders are not part of the business but have a direct interest or involvement in the organization. These compromise of (i) customers, (ii) suppliers, (iii) financiers, (iv) pressure groups, (v) competitors and (vi) the government.

(i) Customers

Customer care is very important in all aspects of business activity. Marshall Field (1834 - 1906), founder of Marshall Field & Company (a chain of American department stores, which was subsequently acquired by Macy's in 2005) said, "*Right or wrong, the customer is always right.*" Sam Walton (1918 - 1992), co-founder of the world's largest retailer Walmart, also believed in this thinking. He argued that customers can simply choose to spend their money elsewhere, thereby threatening the survival of a business.

In ever competitive markets, businesses have to increasingly listen to the opinions of their customers. Bill Gates, co-founder of Microsoft, built his fortunes by meeting the needs of customers all around the world. He said that dissatisfied customers are the best source of learning for any business.

Therefore, it is vital that businesses pay attention to the needs of their customers. These interests or objectives include having greater choice, better quality products and more competitive prices. Businesses use market research (see Chapter 26) to find out what customers want. For example, many businesses such as fast-food restaurants and hotels use customer 'suggestion schemes' and 'satisfaction surveys' to get feedback from their customers. Complaints and suggestions can then be considered by the management team. Ultimately, these actions signify the organization's desire to keep customers happy and loyal.



Figure 4.1 - Customer feedback can provide invaluable information for businesses

(ii) Suppliers

Suppliers provide a business with stocks (inventory) of raw materials, component parts and finished goods needed for production. They can also provide commercial services, such as maintenance and technical support. Suppliers strive for regular contracts with clients at competitive prices. They also request that customers pay any outstanding bills on time.

Businesses try to establish a good working relationship with their suppliers in order to receive quality stocks on time and at a reasonable price. For example, long-haul airline carriers rely on their catering suppliers to provide sufficient meals for their customers, otherwise flights might have to be cancelled if there is a dispute between the airline and the caterers. A good working relationship can also mean that suppliers offer preferential credit terms, which allows a business to purchase today but pay at a later date, thus improving its cash flow position (see Chapter 20).

(iii) Financiers

Financiers are the financial institutions (such as commercial banks and microfinance providers) as well as individual investors (such as business angels) who provide sources of finance for an organization. They are primarily interested in the borrowing organization's ability to generate sufficient profits and to repay the debts as well as making regular interest payments. Financiers earn money by charging interest on the amount of money borrowed.

However, financiers will want to establish a long-term relationship with the borrower in order to generate subsequent earnings if the business requires subsequent loans for its expansion or daily operations.

(iv) Pressure groups

Pressure groups consist of individuals with a common interest who seek to place demands on organizations to act in a particular way or to influence a desired change in their behaviour. Examples include organizations set up to campaign against smoking, deforestation, the harmful treatment of animals, as well as the protection of the natural environment.

Pressure groups have increasingly influenced the decisions and actions of businesses. They often try to achieve their objectives by influencing government policy, such as lobbying for a change in legislation (see Box 4.1). Some pressure groups, such as Friends of the Earth and Greenpeace, do this by operating on an international level and getting support from the general public who are more aware and concerned about damage to the environment.

Box 4.1 - Actions taken by pressure groups

- *Boycotting* is the refusal to buy products from a certain business as a sign of protest, by creating adverse publicity for the business.
- *Lobbying* means using the power of pressure groups to influence key issues with employers, legal representatives and the government, such as petitioning the government to legislate against socially undesirable business activities.
- *Public Relations (PR)* involves getting positive publicity about a specific opinion or cause. For example, charities often use famous celebrity ambassadors to support their mission. PR helps to raise public awareness and support.
- *Direct action* means a pressure group takes action to achieve its cause, such as staging mass protests or taking legal action against firms that may have behaved illegally.

Case study 4.1 - Pressure group in practice



Environmental pressure groups often help with beach clean-ups

Pressure group campaigns such as anti-smoking or anti-littering have led to support from the general public, mass media and governments in many countries. For example, cigarette advertising is banned in Australia whilst littering carries a heavy financial and imprisonment penalty in Singapore. Animal protection groups, such as the World Wildlife Fund, use ethical marketing techniques to gain positive press coverage.

The local community might also put demands (pressure) on businesses to provide jobs in order to create extra income and spending in the area. It might also pressurise businesses to be accountable for the impact of their activities on the local environment. Many popular holiday destinations, for example, have been negatively damaged by the influx of tourists, such as litter, traffic congestion and ecological damage to beaches and rural areas. Finally, the local community might also put pressure on businesses to sponsor local fund-raising events. These considerations are paramount to the local community's acceptance of businesses operating in their area.

(v) Competitors

Competitors are the rival businesses of an organization. For example, the main rivals of Japan Airlines include Singapore Airlines, Qantas, Cathay Pacific Airways and Air China.

It is common for competitors to also hold shares in the business. For example, Cathay Pacific Airways is partially owned by Air China (which holds 28.2% of the shares) and Qatar Airways (which owns 9.4% of the shares). Another example is Porsche, who owns more than 31% of the shares in Audi (which itself is part of the Volkswagen Group).

As a stakeholder group, competitors are interested in the activities of a business for several reasons. Their objectives include:

- To remain competitive - Businesses need to be aware of and respond to the activities of their rivals.
- To benchmark performance - Businesses will want to compare key performance indicators against their main

rivals (such as sales turnover, profit and market share figures) in order to remain relevant.

- To be creative and innovative - Businesses might benefit from some competition as rivalry can create incentives to keep up to date with changes in the internal and external environments (see Chapter 46), such as new production processes or product launches.

ATL Activity 4.1 (Research skills)

Investigate the great rivalries between the likes of Coca-Cola and Pepsi, Ford and General Motors, Boeing and Airbus, McDonald's and Burger King, or Nike and Adidas.

Be prepared to share your findings with the rest of the class.

(vi) Government

The government is an important external stakeholder as it can have a significant influence on business activity. Its interests include assurances that:

- Unfair business practices are avoided.
- The correct amount of corporate tax is paid from the net profits of the business.
- Health and safety standards are met.
- There is compliance with employment legislation.
- Consumer protection laws are upheld.

Governments might also have a financial stake in a business. For example, Air Albania is 51% owned by the Albania government and 49% owned by Turkish Airlines. The Japanese government owns 53.42% of Tokyo Metro Company. Hence, such governments will have a direct interest in the finance performance of the businesses that they own shares in.

Ultimately though, the government strives to ensure that businesses act in the interest of the general public. It can support businesses in this way by policies such as lowering interest rates and/or taxes to create employment and investment opportunities. The government might also offer incentives to multinational companies (see Chapter 6) to locate in their country, such as subsidised rent and tax concessions. It might introduce initiatives that benefit businesses, such as greater investment in roads and communications networks. However, government intervention can also constrain business activities. For example, Microsoft was broken up into two smaller companies due to numerous lawsuits against the software giant for malpractice and unfair competition.

Key concept

Is it **unethical** for a business to give one group of stakeholders priority over the interests of other stakeholder groups?

Business Management Toolkit

Consider the various stakeholder groups of an organization and why they might be interested in its business plan (see Chapter 48).

Question 4.2 - Stakeholders of schools

(a) In the context of high schools, distinguish between the internal and external stakeholders. *[4 marks]*

(b) Explain how the performance of a high school might impact on any **two** of its stakeholder groups. *[6 marks]*

Conflict between stakeholders (AO2)

Stakeholder conflict refers to differences in the varying needs and priorities of the various stakeholder groups of a business. Such conflicting interests mean that it is not possible for a business to meet all of its stakeholder objectives simultaneously.

Stakeholder conflict exists in situations where people disagree with each other due to differences in their opinions or values, thus creating tension between different stakeholder groups of the organization. Margaret Thatcher (1925 - 2013), the UK's first female British Prime Minister, said that standing in the middle of a road would get you hit by traffic coming from both sides, i.e. some of her decisions pleased certain members of the public but she could not please everyone all of the time. This notion also applies to businesses.

Conflict arises because a business cannot simultaneously meet the needs of all its stakeholders. For example, if shareholders want a greater share of the profits, then this may come about by cutting staff benefits such as profit-related pay and performance-related pay (see Chapter10). However, this would obviously upset employees. Another example is that suppliers would like their corporate customers to pay the full price in one transaction, in order to improve their own cash flow, but businesses would expect to receive discounted prices for regular purchases and for buying in large quantities.



Figure 4.2 - Stakeholder conflict exists due to incompatible goals of different stakeholder groups

A common cause of stakeholder conflict is the remuneration (pay and benefits) of the company's directors. Shareholders and employees might argue that top management are 'overpaid' and that there should be a fairer distribution of profits to shareholders (in the form of dividends) and to staff (improved remuneration for employees). Senior executives would argue however that their compensation needs to be adequate to pay for the higher risks involved in decision-making. They claim that this would ultimately increase profits for the business, leading to larger dividend payments and higher wages in the future.

Key concept

In 2021, the *Economic Policy Institute* reported that CEOs (chief executive officers) of the top 350 companies in the US were paid 351 times more than a typical worker in the country. To what extent is it **ethical** for CEOs to be paid so many more times than the average worker?

Another source of potential conflict is that some stakeholders have more than one role or set of interests in an organization. For example, managers are employees too, whilst some employees might also be shareholders of the company they work for. A customer is also likely to be a member of the local community, so may face conflicting interests. Based on the differing objectives of these stakeholder groups, some degree of conflict is likely to occur.

In deciding how to deal with conflicting stakeholder needs, managers need to look at three key issues:

- *The type of business entity* - A partnership (see Chapter 2) might strive for profit maximization, whereas a non-profit organization is likely to have different priorities. So, the owners in a partnership business might regard customers as the key stakeholder group whereas the local community could be the most important group for a charitable organization. A limited liability company will be accountable to its shareholders (owners), so will have to give them priority.

- *The goals and objectives of the business* - If a firm targets growth and expansion as part of its business strategy, then the proportion of profits allocated to its owners will be less important, at least in the short-term. Instead, the priorities of senior managers and directors are given a higher priority to facilitate the change process.

- *The source and degree of power (influence)* for each stakeholder group - Customers will have more power if the business is selling a product in a mass market where there are plenty of substitutes widely available. Access to the media can also give greater power to pressure groups. Likewise, a united workforce will strengthen the influence of employees via their trade union (see Chapter 13).

ATL Activity 4.2 (Thinking skills)

In 2012, prior to Alibaba's record-breaking $25 billion initial public offering (see Chapters 2 and 15), founder and CEO Jack Ma wrote in a letter to investors "Customers first, employees second and shareholders third."

He explained his reasoning behind this by saying that "If the customer is happy, the business is happy and the shareholders are happy."

Discuss the extent to which you think this is the right prioritization for all businesses?

Exam tip !

Be prepared to answer examination questions about:

- the differences between internal and external stakeholders
- the differences between stakeholders and shareholders and
- the various objectives of different stakeholder groups and how these might conflict with each other.

Business Management Toolkit

To what extent might force field analysis (see Chapter 55) help to resolve stakeholder conflict?

Theory of Knowledge (TOK)

Discuss whether it is possible to 'know' which stakeholder group is the most important to an organization. What knowledge issues would be made in such a case?

Question 4.3 - The Royal Bank of Scotland Group

British banking and insurance company The Royal Bank of Scotland Group (RBS Group) has operations in Europe, North America and Asia. Before the global financial crisis of 2008, RBS Group was one of the largest banks in the world. However, its inability to deal with the turmoil in the financial industry led to the UK government buying over 80% of the company's shares. The share price of RBS Group dropped from £3.54 ($4.95) to just £0.11 ($0.16).

To survive, RBS Group had to sell its 4.26% stake in Bank of China, even though it did not make any profit on the deal. RBS Group holds the record for the largest loss in British corporate history; a staggering £24.1bn ($33.8bn) in 2008.

(a) Outline the meaning of RBS Group having a "stake" in Bank of China. *[2 marks]*

(b) Calculate the percentage change in RBS Group's share price. *[2 marks]*

(c) Outline **two** reasons why the shareholders of RBS Group might be concerned about its performance. *[4 marks]*

(d) To what extent should businesses like RBS Group listen to the views of their various stakeholder groups? *[10 marks]*

Question 4.4 - Škoda Auto

Founded in 1895, *Škoda Auto* is one of the oldest automobile manufacturers in the world. In early 2007, the Czech company, which became part of the Volkswagen Group in 2000, entered China as part of its growth strategy. However, in the same year, its workforce in Europe went on strike over concerns regarding the **remuneration** of employees.



It was reported that industrial action cost *Škoda Auto*, the country's largest exporter, 60 million crowns ($2.9m) per day in lost output. Nevertheless, China became Škoda's main market; by 2013, the company had produced its 1 millionth car in China. Today, one in four Škoda cars is sold in China.

(a) Identify **two** external stakeholder groups of *Škoda Auto*. *[2 marks]*

(b) Define the term *remuneration*. *[2 marks]*

(c) Outline **one** source of conflict between *Škoda Auto's* various stakeholders. *[2 marks]*

(d) Examine how the conflict outlined in your answer above could have been minimized. *[6 marks]*

Stakeholder conflict is a potentially ever-present phenomenon. However, modern management thinking suggests that there are mutual benefits in simultaneously meeting the competing or conflicting needs of different stakeholder groups. For example, addressing the needs of both employees and managers can lead to a highly cohesive, motivated and loyal workforce with low rates of staff absenteeism and labour turnover. This can lead to improved customer relations, a better corporate image, higher market share and greater profits in the long-term. As a result, shareholders will also be pleased. Furthermore, greater output might also lead to more employment opportunities in the local community. Hence, it is argued that meeting the needs of all stakeholder groups can be achieved, although this might only occur in the medium to long-term.

Question 4.5 - Royal Dutch Shell



Royal Dutch Shell (or Shell for short) is Europe's largest energy and oil company. It was formed in 1907 by the merger of Royal Dutch from The Netherlands and Shell from the UK. In 2020, the Anglo-Dutch company earned net income of $21.5 billion (that's $2.45m) per hour! This staggering figure obviously drew the attention of Shell's **internal stakeholders.** However, being a global energy and oil company also means that Shell's activities are carefully scrutinised by pressure groups, such as Greenpeace. In 2020, Shell's sales revenue exceeded $180.5 billion (about a fifth of the GDP of the Netherlands).

(a) Define the term *internal stakeholders.* *[2 marks]*

(b) To what extent should a global company such as Shell allow environmental and human rights groups to exert influence on their decision-making? *[10 marks]*

Theory of Knowledge (TOK)

Is it considered unethical if a business chooses to ignore the demands (or needs) of one particular stakeholder group?

Stakeholders and the key concepts

Conflict exists in every organization, at least to some extent, so this needs to be managed carefully. At times, employees will disagree with management decisions about change (see Chapters 7 and 55); customers will be disgruntled, especially if the business acts unethically; suppliers will fail to deliver the right goods on time; shareholders will be unhappy with the performance of the business and so forth. Given the potential mutual benefits of meeting the contrasting interests of various stakeholder groups, conflict resolution is an important aspect of any sustainable business strategy.

However, it is unlikely that a business can fulfil the objectives of all its stakeholders at the same time, all of the time. Nevertheless, it is unrealistic or undesirable to maximize the needs of just one single stakeholder group. If a particular group is not catered for, then it is possible that they will cause interruptions and problems for the business. Most strategies aim for a 'best fit' compromise so that the needs of all stakeholder groups are reasonably addressed.

The outcome of any negotiation between various stakeholder groups will depend largely on the *culture* of the organization (see Chapter 11) and the *relative bargaining power* of the different stakeholders. For example, large multinational companies such as Honda or Ford have better bargaining power with their suppliers than mechanics operating as sole traders trying to negotiate prices for motor vehicle parts.

A common stakeholder conflict management tool is **stakeholder mapping.** This model considers the relative *interest* of stakeholders and their relative *power* (or influence) on businesses, as shown in Figure 4.3.

		Level of interest	
		Low	*High*
Level of power	*Low*	**A** (minimum effort)	**B** (keep informed)
	High	**C** (keep satisfied)	**D** (maximum effort)

Figure 4.3 - Stakeholder mapping

Stakeholder mapping lets managers assess how to deal with changing and conflicting stakeholder objectives. Whilst it is extremely difficult to please all stakeholders at the same time, managers can prioritize their actions by using this model. Stakeholders in quadrant A are unlikely to receive much attention from the decision makers. Conversely, those in quadrant D will receive the most attention as they are the key stakeholders of an organization. Stakeholders in quadrant B need to be kept informed whilst those in quadrant C must be kept satisfied, perhaps by consulting them on strategic decisions.

In reality, managers will deal with stakeholder conflict in different ways depending on their management and leadership style (see Chapter 9) and the organizational culture (see Chapter 11). For example, paternalistic leaders would argue that although customers are vital to any business, it is the needs of employees that have to be considered first. They believe that by hiring the right people and devoting time and money to train and develop employees, workers will automatically deliver a first-rate service to their customers.

Furthermore, external stakeholders such as pressure groups have become increasingly effective in influencing business activity through changes in digital social media platforms. Due to public awareness of the detrimental effects of globalization (such as the exploitation of child labour or the impact of business activity on global warming and sustainability issues), organizations are finding it ever more difficult to simply ignore ethical business behaviour and the associated pressures from external stakeholder groups.

Business Management Toolkit

To what extent might the use of force field analysis as a business management tool (see Chapter 55) help with resolving stakeholder conflict?

Theory of Knowledge (TOK)

Are the values and beliefs of some stakeholders more important than those of others?

Key concept

Does organizational **change** always lead to conflicting stakeholder objectives?

Key concept

With reference to an organization of your choice, examine how business **ethics** impact both internal and external stakeholders.

REVIEW QUESTIONS

1. What is a stakeholder?
2. How do internal stakeholders differ from external stakeholders?
3. Who are the main internal stakeholders of a business?
4. What examples are there of external stakeholders?
5. What is the difference between a stakeholder and a shareholder?
6. Why are shareholders a potentially powerful stakeholder group?
7. Why might competitors be considered as external stakeholders?
8. What is the role of the government as a stakeholder group in business activities?
9. What is meant by stakeholder conflict?
10. How might a business resolve stakeholder conflict in the workplace?

KEY TERMS

Conflict refers to situations where stakeholders have disputes or differences regarding certain issues or matters. This can lead to arguments and tension between the various stakeholder groups.

Customers are the clients of a business. As a key external stakeholder group, customers seek to have value for money, such as competitive prices and good quality products.

Directors are senior executives who have been elected by the company's shareholders to address business activities on behalf of their owners.

Employees are the staff of an organization. They have a stake (an interest and involvement) in the organization they work for.

External stakeholders are individuals and organizations not part of the business but have a direct interest in its activities and performance. Examples include customers, suppliers and the government.

Financiers are the financial institutions and individual investors who provide sources of finance for an organization. They are interested in the organization's ability to generate profits and to repay debts.

Government refers to the ruling authority within a state or country. As an external stakeholder group, the government is interested in businesses complying with the law with regards to the conduct of business activities.

Internal stakeholders of a business are members of the organization, namely the employees, managers, directors and shareholders (owners) of the business.

The **local community** refers to the general public and local businesses that have a direct interest in the activities of an organization, namely to create jobs and to conduct business activities in a socially responsible way.

Managers are an internal group of stakeholder responsibly for overseeing the daily operations of the business.

Pressure groups consist of individuals with a common concern (such as environmental protection) who seek to place demands on organizations to act in a particular way or to influence a change in their behaviour.

Stakeholder conflict refers to differences in the varying needs and priorities of the various stakeholder groups of a business.

Stakeholder mapping is a model that assesses the relative *interest* of stakeholders and their relative influence (or power) on an organization.

Shareholders (or **stockholders**) are the owners of a limited liability company. Shares in a company can be held by individuals and other organizations.

Stakeholders are individuals or organizations with a direct interest (known as a *stake*) in the activities and performance of a business, such as shareholders, employees, customers and suppliers.

Suppliers are an external stakeholder group that provide a business with stocks of raw materials, component parts and finished goods needed for production. They can also provide commercial services, such as maintenance and technical support.



Figure 4.3 - Suppliers are an important external stakeholder group

Chapter 5
Unit 1.5 - Growth and evolution

"It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change."
- Anton P. Chekhov (1860 - 1904), Russian playwright

Contents

1.5 Growth and evolution	
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Reasons for businesses to stay small	AO3
External growth methods: • Mergers and acquisitions (M&As) • Takeovers • Joint ventures • Strategic alliances • Franchising	AO3

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Economies and diseconomies of scale (AO2)

Internal and external economies and diseconomies of scale

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A major reason why businesses aim to grow is to benefit from **economies of scale**. This refers to lower average cost of production as a firm operates on a larger scale due to an improvement in its productive efficiency. Economies of scale can help businesses to gain a competitive cost advantage because lower average costs can mean a combination of lower prices being charged to customers and a higher profit margin earned on each item sold.

The **average cost** (AC) is the cost per unit of output. It is calculated by dividing total costs (TC) by the quantity of output (Q), i.e. AC = TC ÷ Q. For example, if total costs of producing 10,000 shirts is $78,000 then the cost of each shirt is $7.80.

Average cost consists of two components: **average fixed costs** (AFC) and **average variable costs** (AVC). AFC is calculated by dividing the total fixed cost (TFC) by the level of output, i.e. AFC = TFC ÷ Q. Similarly, AVC is calculated by dividing the total variable cost by the level of output, i.e. AVC = TVC ÷ Q.

The average fixed costs of a firm will decline continuously with larger levels of output. This is because the TFC remains constant but is spread over an increasing amount of output, i.e. the same (fixed) costs are being divided by a larger number (level of output) as shown in Figure 5.1.

As a firm operates on a larger scale, economies of scale are experienced, up to the **optimal level of output** (where average costs are minimised). Thereafter, any further increases in output bring about diseconomies of scale, i.e. higher average costs as output increases

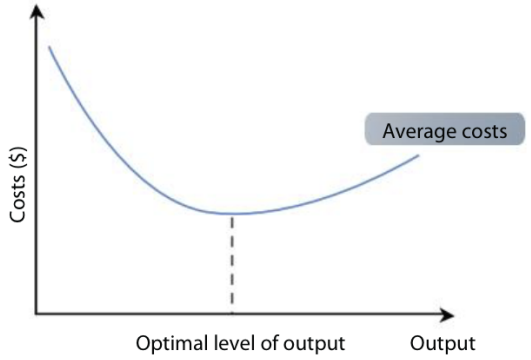

Figure 5.1 - Economies and diseconomies of scale

Firms minimize their costs by operating at the output level where average costs are at their lowest (the optimal level of output). Economies of scale that occur inside the firm and are within its control are known as **internal economies of scale.** Those that occur within the industry and are generally beyond an individual firm's control are known as **external economies of scale**.

Internal Economies of Scale

By operating on a larger scale, a business can reduce its average cost of production due to any combination of the types of internal economies of scale below. The relative importance of each depends on the actual business under consideration.

- **Technical economies** - Large firms can use sophisticated capital and machinery to mass produce their products. For example, due to the huge scale of production, the Philips factory in Shenzhen, China produces complete audio systems within a few seconds! The high fixed costs of their equipment and machinery are spread over the huge scale of output, thereby reducing the average cost of production. Small businesses do not find it feasible or cost-efficient to buy and use such technologies.

- **Financial economies** - Large firms can borrow large sums of money at lower rates of interest compared to smaller competitors because the larger organizations are seen as less risky to financial lenders. In addition, a large and established business looking to borrow money will probably choose a lender that offers the most attractive interest rate, i.e. there is rivalry amongst the financiers to lend to large and reputable businesses. By contrast, smaller firms often struggle to raise external finance and are charged higher interest rates on their borrowing due to the higher degree of risk involved.

Case Study - The Airbus A380

The Airbus 380, the world's largest passenger plane, has 49% more seating capacity than its rival Boeing 787 Dreamliner, yet burns 17% less fuel per seat. Hence, the average cost of fuel for Airbus is lower. This is particularly important for Airline carriers operating in a highly competitive industry where fuel prices account for a large proportion of their costs (the A380 has a fuel capacity of 81,890 gallons or 310,000 litres) and where the price of aircraft is hugely expensive - the Boeing 787 Dreamliner costs over $257m and the Airbus A380 costs $418m per plane! However, low demand from airline carriers (especially following the aftermath of the global COVID-19 pandemic) meant that Airbus ceased to produce the A380 at the end of 2021.



- **Managerial economies** - A sole trader (see Chapter 2) often has to fulfil the functions of marketer, accountant and production manager. As people cannot be equally good at everything, *specialisation* leads to higher productivity. By contrast, large firms divide managerial roles by employing specialist managers. Through growth, a business can avoid a duplication of effort in planning, communication, marketing, distribution and production processes. The higher productivity means that average costs can fall further.

- **Specialization economies** - This is similar to managerial economies of scale but results from division of labour of the workforce, rather than the management. Motor vehicle manufacturers that use mass production techniques benefit from having specialist labour including designers, production staff, engineers and marketers. These specialists are responsible for a single part of the production process and their skills and expertise mean that there is greater productivity thereby helping to reduce the average cost of output.

- **Marketing economies** - Large firms can benefit from a lower average cost by selling in bulk, thus benefiting from time savings and transactions costs. For example, a small retail outlet might sell 1,000 cans of Coca-Cola in a month to hundreds of different customers. This will cost a lot more than the Coca-Cola Company that can sell 1,000 cans in just one transaction to a single customer (such as a supermarket). Global firms such as McDonald's and Nike can spread the high costs of their advertising by using the same marketing campaign across the world (language translation is a minor part of the costs of a global marketing budget).

- **Purchasing economies** - Large firms can also lower their average costs by buying resources in bulk. Note, however, that even relatively small firms can gain from purchasing economies of scale because they also gain discounts for bulk purchases. Of course, the larger the order the greater the bulk discount might be, so there is still an advantage to being big in the corporate world.

- **Risk-bearing economies** - These savings can be enjoyed by *conglomerates* (firms with a diversified portfolio of products in different markets). Conglomerates such as Reliance Industries (see Case study 5.1) can spread their fixed costs, such as advertising or research and development, across a wide range of their operations. Unfavourable trading conditions for certain products or industries can be offset by more favourable conditions in other sectors of the conglomerate. Hence, a loss in one area of their business does not jeopardise the business overall.

Case study 5.1 - Reliance Industries

Reliance Industries is an Indian multinational conglomerate company headquartered in Mumbai, India. It is one of the world's largest conglomerates and India's largest publicly held company. It has strategic business units in markets as varied as energy, financial services, logistics, mass media, natural gas, petrochemicals, retail, telecommunications and textiles.

Common mistake

Many students define economies of scale as 'the benefits of bulk buying'. However, even *small* businesses can buy in bulk; the term refers to the cost-saving or cost-reducing benefits enjoyed by firms engaged in *large* scale operations. Financial, technological and managerial economies of scale are probably far more important in reducing the average cost of production for most businesses than their ability to buy in bulk.

External economies of scale

External economies of scale are cost-saving benefits of large-scale operations arising from *outside* the business due to its favourable location or general growth in the industry. These benefits are also enjoyed by other firms within the industry. Examples of external economies include:

- **Technological progress** increases the productivity level within the industry. For example, the Internet has created huge cost savings for businesses engaged in e-commerce. Online retailers, for example, do not have to be located in central business districts thereby avoiding highly expensive rent.

- **Improved transportation networks** help to ensure prompt deliveries. Furthermore, employees who are late to work due to poor transportation links cost the business money. Customers and suppliers also want convenience (ease of access). Ultimately, congestion and inefficiencies raise business costs and reduce profits.

- An abundance of **skilled labour** might exist in the local area, perhaps through government aided training programmes or reputable education and training facilities in a certain location. This provides local businesses with a suitable pool of educated and trained labour, thereby helping to cut recruitment and training costs (see Chapter 7) without compromising productivity levels.

- **Regional specialisation** means that a particular location or country has a highly regarded and trustworthy reputation for producing a certain good or service. For example, Murano, in Venice, Italy, is famous for its glass products such as vases, jewellery and chandeliers. This allows the industry to benefit from having access to specialist labour, sub-contractors and suppliers, thus helping to reduce the average cost of production for the industry. Its reputation also allows firms in Murano to charge premium prices (see Chapter 28) for its products.



Figure 5.2 - Growth brings benefits such as economies of scale

Internal diseconomies of scale

Contrary to popular belief, businesses can become too large. There comes a 'tipping point' when economies of scale no longer exist. **Diseconomies of scale** are the result of higher unit costs as a firm continues to increase in size. This means that the business becomes outsized and inefficient, so the average cost of production begins to rise (see Figure 5.1). **Internal diseconomies of scale** usually occur due to problems of mismanagement. Examples include:

- As a firm becomes larger, managers may **lack control and coordination** as the span of control (see Chapter 8) is likely to increase and cause communication problems. Ultimately, these difficulties slow down decision-making. Coordination and control problems also occur for organizations with business operations in different locations throughout the world. Workers in larger organizations might feel a sense of alienation, which can harm staff morale (see Chapter 10). These issues add to the firm's costs without any corresponding increase in productivity, thereby raising its unit costs.

- There is likely to be **poorer working relationships** in an oversized business. With a larger workforce, senior managers are more likely to become detached from those lower down in the organizational hierarchy, thereby making them feel distanced or out of touch. This can damage communication flows and the motivation of staff, thereby reducing their productivity and leading to higher average costs.

- Outsized organizations are likely to suffer from the disadvantages of specialization and division of labour. Workers become bored with performing repetitive tasks. With a larger workforce, there may also be scope for slack (inefficiencies and procrastination). This leads to **lower productive efficiency** and hence an increase in the average costs of production.

- The amount of **bureaucracy** (excessive administration, paperwork and company policies) is also likely to increase as a business grows. This makes decision-making more time consuming and adds to production costs but is unlikely to contribute to a proportional rise in the output of goods and services. Bureaucracy can also make communication more challenging, thereby worsening working relationships and again contributing to higher unit costs.

- **Complacency** with being a large and dominant firm with market power or even being the market leader can also cause many problems. Complacency (a lack of awareness of genuine risks or deficiencies) is most likely to reduce productivity thereby raising unit costs of production.

The potential for large firms to experience diseconomies of scale means that some businesses prefer to grow via **franchising** (covered later in this Unit). Multinational companies such as McDonald's and 7-Eleven have used this strategy to expand their businesses and to raise brand awareness (see Chapter 27), without having to face the higher average costs of being large.

External diseconomies of scale

External diseconomies of scale occur once there is an increase in the average cost of production when a firm grows due to factors beyond its control. Such problems affect the whole industry, often because there are just too many firms competing in the market. Hence, average costs of production increase for all businesses in the industry. Examples include:

- Too many businesses locating in a certain area causes land to become even more scarce thereby causing **higher rents**. This adds to the fixed costs of all businesses in the area without any corresponding increase in output. Hence, unit costs will rise. The high demand for businesses to locate in busy districts such as Manhattan (New York City), Shinjuku (Tokyo), The City (London) and Silicon Valley (San Francisco) has resulted in a sustained and continuous rise in the rental value of land in these prime city locations.

- Since workers have greater choice from a large number of employers in the local area, businesses might have to offer **higher pay and financial rewards** to retain workers or attract new staff. This will increase costs without necessarily increasing output, thereby raising average costs of production for all firms in the industry.

- **Traffic congestion** results from too many businesses being located in an area. Deliveries are likely to be delayed due to the overcrowding. This increases transportation costs for businesses, thereby contributing to an increase in unit costs of production.



Figure 5.3 - Traffic congestion is a cause of external diseconomies of scale

The difference between internal and external growth (AO2)

Internal growth occurs when a business grows organically, using its own capabilities and resources to increase the scale of its operations and sales revenue. It is typically financed through a combination of retained profits, borrowing and issuing of new shares. A business can grow internally in several ways such as:

- Changing **price** - More customers tend to buy a product at lower prices. However, if there are very few substitutes for the product, demand is said to be price inelastic (see Chapter 28), so the business will earn more revenue by *raising* prices. For products in highly competitive markets, demand is price elastic so a reduction in the selling price will tend to generate proportionately more sales revenue

- Improved **promotion** - People are more likely to buy a product if they are informed, reminded and/or persuaded about its benefits. The Coca-Cola Company spends around $3bn each year on promoting its products, which is one reason why it is the world's most recognised brand with sales of 1.9 billion servings each day.

- Producing improved or better **products** - Through methods such as market research, innovation and new product development, businesses can produce products that are more appealing to the market, thereby raising their sales. Most newly launched products actually fail, so it is quite common for businesses to improve on the design and/or features of an existing product. Nevertheless, product innovation can be a lucrative source of internal growth.

Case study 5.2 - Apple

Apple's internal growth strategy focuses on new product development and launching new product innovations. Examples include Apple's product launches of the iPod, iPad, iPhone, iMac Pro, MacBook Air, MacBook Pro, Apple TV, Apple Watch, HomePod, AirPod, iTunes and the App Store.

- Selling through a greater distribution network (**placement**) - If a product is widely available, customers are more likely to buy it. One of the world's most expensive production cars is the Lamborghini Veneno, with a selling price of $4.5m (although the most expensive one was sold for $8.27 million). Apart from the price, the Lamborghini Veneno is very limited in supply, so this restricts the potential

number of customers. Coca-Cola, on the other hand, is widely available throughout the world in different places, such as supermarkets, wholesalers, restaurants, cinemas, aeroplanes and vending machines. Having more retail outlets, despite the higher costs, can also help to achieve internal growth.

- Offer preferential **credit** - Customers are more likely to make a purchase if they are offered the option to 'buy now and pay later'. Allowing customers to pay in regular instalments perhaps over 12 or 24 months for the purchase of expensive products, such as motor vehicles, home furniture or large-screen televisions, can attract more customers to the market. However, businesses must be careful not to offer too much credit as this can affect their cash flow position (see Chapter 20).

- Increased **capital expenditure** (investment spending) - This can be in the form of internal expansion of the business to new locations or the introduction of new production processes and technologies in order to improve productivity. However, investment risks might not pay off, so careful planning and the use of additional tools such as investment appraisal (see Chapter 21) may be required.

- Improved **training and development** - People (employees) are often said to be a firm's most important asset (see Chapter 7). Training and development are important as customers are unlikely to buy from salespeople who have little or no product knowledge. Training and development not only help to make employees more confident and competent in their jobs, but it can also help to motivate the workforce as they feel more valued by the employer (see Chapter 10). This can improve the quality of customer service, thus contributing to greater customer loyalty and higher sales for internal growth.

- Providing overall **value for money** - Businesses that can provide improved value for money are most likely to experience internal growth. Customers tend to look at more than just the price when making purchasing decisions. Other factors may include product quality, after-sales care, brand image, maintenance costs and environmental considerations.

CORE

Table 5.1 - The advantages and disadvantages of internal growth

Advantages of internal growth	Disadvantages of internal growth
Better **control and coordination** - It is often easier to grow internally than to rely on external sources. Internal growth also enables the organization to maintain control, whereas external growth can lead to a loss of control and ownership of the business.	**Diseconomies of scale** - Higher average costs of production can arise from internal growth. Hierarchical structures (see Chapter 8) tend to be a feature of internal growth, causing communication problems and slower decision-making as a business grows.
Relatively **inexpensive** - The main source of internal growth is retained profits. There might also be a need to secure interest-bearing loan capital to fund the growth, but there is less risk involved with internal growth as the amount of capital tends to be lower. The higher cost of external growth means that for many firms, internal growth is the only suitable option.	A need to **restructure** - Although a sole trader can control and coordinate the business quite easily, if it grows into a multinational company then the organizational structure has to be changed. Restructuring takes time, effort and money, such as training needs. Specialist managers also have to be hired as the firm and its workforce grows.
Maintains the **corporate culture** - A major problem for mergers and acquisitions is that when two or more firms with very different cultures work together to create a new company. By contrast, internal growth means there are no problems related with culture clashes (see Chapter 11) or conflicting management styles.	**Dilution of control and ownership** - If a firm grows by changing its legal status, say from being a partnership to a publicly held company, the owners (the partners) will have to share decision-making power with the new owners (shareholders). With more owners, decision-making is prolonged and conflicts between the different stakeholders are more likely.
Less risky - Due to the above reasons, internal growth is the easiest and least risky method of growth and evolution for most businesses. Furthermore, internal growth builds on the strengths of the organization, such as its brand value and customer loyalty.	**Slower growth** - Internal growth is slower than external growth. Despite the risks, shareholders may prefer more rapid methods of growth (such as mergers, acquisitions, takeovers or franchising, in order to increase their return on investment.

Question 5.1 - Poundland

British discount retailer Poundland has built a reputation for internal growth. Founded in 1990, Poundland opened its 500th store in 2014 and had more than 800 stores at the start of 2022. Poundland, which sells most of its products for £1 ($1.40) or less, serves 7 million customers each week and has reported annual increases in profits by as much as 29%. Its growth strategy is to focus on expansion in Ireland, the Netherlands and the UK in order to gain greater **market share**.

(a) Define the term *market share.* *[2 marks]*

(b) Describe **two** methods of internal growth that Poundland might have used. *[4 marks]*

(c) Discuss the extent to which internal growth is desirable for a business such as Poundland. *[10 marks]*

External growth (or inorganic growth) occurs through dealings with outside organizations rather than from an increase in the organization's own business operations. External growth usually comes in the form of mergers and acquisitions (M&As), takeovers, joint ventures, strategic alliances, or franchising (all of which are explained below). These growth methods are collectively referred to as the **amalgamation** or **integration** of firms. The advantages and disadvantages of external growth are outlined in Table 5.2



Figure 5.4 - External growth helps to build a firm's market share.

Table 5.2 - The advantages and disadvantages of external growth

Advantages of external growth	Disadvantages of external growth
Quicker than organic growth - External growth tends to be a faster way to grow and diversify as external resources and finances are used.	**More expensive than internal growth** - M&As, JVs, strategic alliances and franchising tend to be more expensive than internal growth methods.
Synergies - Businesses can benefit from a greater pool of skills, knowledge and the expertise of external parties.	**Greater risks** - Inadequate knowledge of new markets and the greater uncertainties of external growth create greater risks.
Reduced competition - External growth is a relatively quick, albeit expensive, method of reducing the degree of competition and raising the firm's market share.	**Regulatory barriers** - External growth, such as acquisitions and takeovers, can be blocked by governments if the move is deemed to be anti-competitive.
Economies of scale - Rapid external growth can help businesses to gain access to larger markets and hence economies of scale from operating on a larger scale.	**Potential diseconomies of scale** - Increased complexities of internal growth can equally cause inefficiencies and hence a rise in average costs.
Spreading of risks - External growth enables businesses to benefit from diversification. Hence, firms face fewer risks overall from failures in any particular aspect of its business operations.	**Organizational culture clash** - It is often difficult to combine different cultures and management styles, especially if external growth leads to a change in the nature and culture of a business.

Question 5.2 - A.S. Watson Group

With a history dating back to 1828, A.S. Watson Group has evolved into the world's largest international health, beauty and lifestyle retailer. It has operations in over 16,000 stores across 27 markets worldwide, with over 5.3 billion customers each year.

A.S. Watson Group employs over 140,000 staff and its **product portfolio** includes some of Asia's best-known brands and retail chains, including Watsons (health and beauty), PARKnSHOP (supermarkets), Fortress (electrical appliances), Watson's Wine and Nuance-Watson airport duty free shops. It is also a major producer and distributor of water products and beverages, including brands such as Sunkist and Mr. Juicy. In Europe, its health and beauty brands include Superdrug, Rossmann, Trekpleister, Drogas and Spektr. Its luxury perfumery cosmetics brands include ICI Paris XL, Marionnaud and The Perfume Shop. Growing the business remains a long-term goal at A.S. Watson Group.

Source: adapted from A.S. Watson Group (www.aswatson.com)

(a) Define the term *product portfolio.* *[2 marks]*

(b) Suggest the type of business entity that A.S. Watson Group might be classified as. [2 marks]

(c) Explain how A.S. Watson Group benefits from synergy by its growth and evolution strategies. [4 marks]

(d) Despite its enormous size and global presence, examine why A.S. Watson Group still aims to grow larger as part of its long-term corporate strategy *[6 marks]*

CORE

Business Management Toolkit

Discuss how the use of descriptive statistics (see Chapter 50) can assist decision-makers about internal and external growth strategies.

Reasons for businesses to grow (AO3)

All businesses have an appropriate scale of operation. For instance, the market for smartphones is enormous whereas that for IB textbooks is smaller. The size of a business can be measured in several ways:

- *Market share* - a firm's sales revenue as a percentage of the industry's total sales revenue.
- *Total sales revenue* - the value of a firm's annual sales revenue for a given time period, usually per year. This measure gives an indication of the size of the firm's customer base.
- *Size of workforce* - the total number of employees hired by the business per time period.
- *Profit* - the value of a firm's profits per time period.
- *Capital employed* - the value of the firm's capital investment as recorded on its balance sheet (see Chapter 17).

An increase in the value of any of the above measures would suggest that the firm is growing. Essentially, the size of a business is measured in relative terms by comparing benchmark data to those of its competitors. The interrelated benefits of being a large business organization are show in Table 5.3.

Table 5.3 - Generic benefits of being a large business

Advantages of external growth	Disadvantages of external growth
Economies of scale	These are cost-saving benefits due to operating on a larger scale, which reduces the firm's average cost of production.
Lower prices	Larger firms are able to offer customers greater price discounts through their ability to enjoy economies of scale.
Brand recognition	Familiarity with the brand allows large businesses to sell to a wider market. Many firms are large and established enough to benefit from global brand recognition.
Brand reputation	Larger firms tend to be more trusted due to their brand image and brand reputation.
Value- added services	Larger firms have the resources to provide a wider range of services for their customers, such as longer opening hours and interest-free credit instalments.
Greater choice	Larger firms can provide more choice for their customer. For example, Amazon offers a larger range of books, toys and music compared to a small local book shop, toy store, or music retailer.
Customer loyalty	The above benefits mean that more customers are likely to remain loyal to the business, its products and its brands due to the perceived trust and overall value for money.



Figure 5.5 - Small firms tend to only sell a limited range of goods

Large companies such as Apple, BMW, Coca-Cola and IKEA design and market their products to a global audience. Consumers around the world easily recognize and trust their brands and products. In the case of McDonald's, even the production processes are largely the same throughout the world; burgers and fries are cooked in exactly the same way irrespective of where the McDonald's restaurant is located in the world. The Coca-Cola brand is one of the most recognized in the world. Thus, these large businesses are able to exploit global marketing and production economies of scale as they grow and evolve.

Case study 5.3 - IKEA

Founded in 1943, IKEA is the world's largest retailer of home furniture, kitchen appliances and home accessories. It was not until 1963 that IKEA opened its first overseas stores in neighbouring Norway and later in 1969 in Denmark. The Swedish company has since grown to over 445 stores in 50 countries and employs more than 225,000 people around the world.

Case study 5.4 - Amazon

Amazon was founded in 1994 by Jeff Bezos, operating the business from his garage in Washington, USA. Originally an online bookstore, the business earned $20,000 in sales revenue per week within its first two months of trading. However, it wasn't until 2001 when the company declared its first profit. Today, the company focuses on a lot more than just books, with operations in e-commerce, cloud computing, digital streaming and artificial intelligence. Amazon has continued to grow with operations across North America, Latin America, Europe, Africa and Asia. It employs over 810,000 workers in the USA and earns over $386bn in annual sales revenue. Today, Bezos is one of the world's wealthiest people.

Business Management Toolkit

Discuss how role of Ansoff's matrix (see Chapter 45) in decision making about organizational growth strategies.

Reasons for businesses to stay small (AO3)

Despite the benefits of being large, small firms can still thrive. The main reasons why businesses may stay small are outlined in Table 5.4.

Table 5.4 - Reasons for staying small as a business

Reason	Explanation
Cost control	Large scale operations can mean that a firm encounters diseconomies of scale due to problems of control, coordination and communication. Owners of small firms might not want to expand as they could face higher unit costs. Growth can also require additional borrowing costs.
Loss of control	External growth through methods such as mergers and acquisitions (M&As) and takeovers may result in the dilution of ownership and control for the original owners.
Financial risks	As the costs of running a large global business are huge (such as the costs of research and development, marketing, recruitment and training), the financial risks are also high. By contrast, owners of small businesses can better manage and control their finances.
Government aid	Financial support in the form of grants and subsidies can be offered to small businesses to help them start up and to develop. Funds for training may also be available for small businesses that provide employment opportunities in the local community.
Local monopoly power	Small businesses may enjoy being the only firm in a particular location, such as a local restaurant, a franchised petroleum retailer, or a small convenience store located in a remote town. Large businesses may be reluctant to locate in remote areas (see Chapter 38), so this provides an opportunity for smaller firms to establish themselves in the area.
Personalised services	Smaller firms are more likely to have the time to devote to individual customers. For example, staff at a small local convenience store can get to know their customers better as employees are not pressurised by high sales targets. By contrast, large supermarkets rely on a high number of customers being served with many using self-checkout services.
Flexibility	Small businesses tend to be more flexible and adaptive to change. If a sole trader runs a beauty salon that is unsuccessful, then s/he might change the business to something completely different, such as a children's toy shop. Large businesses have large financial commitments and conflicting stakeholder objectives (see Chapter 4) which combine to reduce their ability to change in the same way.
Small market size	Some businesses, such as a local hair salon or private tuition firm, are unlikely to attract the attention of large firms due to the very limited size of the market. Large corporations may not find it financially worthwhile to compete with these small local firms, thereby enabling them to thrive.



Figure 5.6 - Small businesses can thrive despite the existence and benefits of larger firms

The optimal (most appropriate) size for a business depends on its internal structure, its finances and its aims and objectives. For example, Mars and IKEA are privately held companies (see Chapter 2) as the owners want the businesses to remain in the control of the founding families rather than external owners (shareholders and directors). If a firm operates beyond its optimal size (meaning it becomes too large) then diseconomies of scale will set in, which results in higher unit costs and lower profits.

In reality, a firm might not operate at its optimal level due to a lack of resources. It cannot expand if it does not have appropriate resources and sufficient sources of finance. Furthermore, it cannot increase output if it lacks the productive capacity (see Chapter 40) to do so. The firm will also choose not to expand output if there is insufficient demand, even if producing more means lower average costs.

Question 5.3 - Small versus Large

Businesses come in all different sizes. For example:

- The vast number of businesses are owned by sole traders who only supply a limited number of products.
- Airbus and Boeing dominate the commercial aircraft industry, manufacturing aeroplanes for airline companies only.
- Ferrari and Rolex supply luxury goods to a relatively small consumer market.
- Ford, General Motors and Toyota mass produce their cars to a global market.
- Samsung, Apple and Huawei collectively produce billions of smartphones.
- Burger King, KFC and McDonald's have fast-food restaurants across the world.
- Microsoft supplies computer software for over 90% of the world's personal computers.

Some businesses prefer to stay small. Rolex and Ferrari, for example, deliberately limit growth in their operations. Others, such as McDonald's and Toyota, continually strive for expansion.

(a) Outline why economies of scale might benefit customers. *[2 marks]*

(b) Explain why economies of scale might be inappropriate, undesirable or inaccessible for certain businesses. *[4 marks]*

(c) Explain why so many small firms continue to survive and thrive, despite their limited ability to access economies of scale. *[4 marks]*

(d) To what extent do large businesses operate in the best interest of the general public? *[10 marks]*

Question 5.4 - Hoang Tan



Hoang Tan is a small business specialising in clothing products for men. Established in 2018, Hoang Tan has expanded its operations in two other locations in South Vietnam. However, the owner has struggled to secure external finance for its planned growth in neighbouring countries Laos and Cambodia.

(a) Define the term *growth*. *[2 marks]*

(b) State **two** reasons why banks might be reluctant to fund the expansion plans of *Hoang Tan*. *[2 marks]*

(c) Explain **two** problems that *Hoang Tan* might encounter by operating in new overseas markets such as Laos and Cambodia. *[6 marks]*

Key concept

In a world of uncertainty and continual **change**, is it possible to achieve both growth and profit in a **sustainable** way?

Theory of Knowledge (TOK)

How can managers and business owners know whether growth is beneficial, given the risks and uncertainties involved?

External growth methods (AO3)

External growth methods: (i) mergers and acquisitions (M&As), (ii) takeovers, (iii) joint ventures, (iv) strategic alliances and (v) franchising. AO3

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(i) Mergers and acquisitions (M&As)

The phrase 'mergers and acquisitions (M&As)' refers to the consolidation or integration of two or more businesses to form a single company. The new and larger business entity will usually benefit from improved synergies, such as economies of scale and have a larger share of the market(s) that it operates in. M&As also entail a restructuring of the company's organizational structure (see Chapter 8).

A **merger** takes place when two or more firms agree to create a new company with its own legal identity. An example is the merger between the UK's British Petroleum and the US oil company Amoco in 1998 to form 'BP Amoco' - which has since been renamed and shortened to 'BP'. Other examples of large mergers include Daimler Benz and Chrysler (1998), Glaxo Wellcome and SmithKline Beecham (2000), Hewlett-Packard and Compaq (2001), American Airlines and US Airways (2013) and Just Eat and Takeaway.com (2020). The merger usually requires a new company name to be used (given it has a new legal identity), along with a Board of Directors that is composed of executives from both or all the companies involved.

Case study 5.5 - American Airlines Group

On Valentine's Day 2013, US Airways and American Airlines agreed to merge in a deal worth $11 billion to create the world's largest airline, with 6,700 daily flights and annual revenues of over $42 billion. The airlines claimed the deal would offer passengers more travel options but probably at higher prices. Government regulators had initially blocked the merger as it was not deemed to be in the best interest of the general public, but the merger was eventually completed in December 2013 with the airlines being renamed American Airlines Group Inc.

An **acquisition** occurs when a company buys a *controlling interest* in another firm with the permission and agreement of its Board of Directors to do so. This means the acquiring company buys enough shares in the target company to hold a majority stake. The acquiring company (purchaser) must buy more than 50% of the target company's shares in order to gain absolute control over it. For example, Google acquired YouTube for just $1.65 billion in 2006 - although this wasn't a bad deal for the co-founders of YouTube who had only been in business for 10 months at that time!

Unlike a merger which usually involves the integration businesses of similar sizes, an acquisition usually occurs between two companies that are not of equal stature - typically, the larger and more financially powerful business acquires the smaller one. For example, Amazon acquired the American supermarket chain Whole Foods Inc. in 2017 for $13.7 billion. Although Whole Foods still operates under its original name, all of its business operations are controlled by Amazon as the parent company.

Mergers and acquisitions create **synergy**. Synergy occurs when the whole is greater than the sum of the individual parts when two or more businesses are integrated. Essentially, synergy creates greater output and improved efficiencies, which is a major reason why organizations seek to grown inorganically. Table 5.5 outlines the benefits and drawbacks of mergers and acquisitions as forms of external growth strategies.

Case study 5.6 - AT&T and WarnerMedia merger

In 2018, American multinational conglomerate AT&T agreed to acquire WarnerMedia, a multinational mass media and entertainment corporation, in a deal worth $43 billion. AT&T is the world's largest telecommunications company and America's largest provider of mobile telephone services. The merger enabled AT&T to gain access to markets under the brands of HBO, Cinemax, CNN and Warner Bros.

Common mistake

Students will often claim that a business needs to buy at least 51% of the shares in another company in order to acquire it. Buying 50% plus 1 share will guarantee the acquisition but this might prove too expensive and is not a necessary condition. Buying a majority stake (which can be less than 50%) will still give the purchaser control of the acquired business.

There are four types of integration or consolidation that can occur in a merger or acquisition:

- **Horizontal integration** is the most common type of M&A, which occurs when there is an amalgamation of firms operating in the same industry. For example, America's Nike acquired the UK's Umbro (both in the sports apparel industry) in 2007 for $580 million. Carlsberg, the Danish beer maker, acquired China's largest beer producer Chongqing Brewery in December 2013. Horizontal M&As do not represent growth in the industry but a larger market share and hence greater market power (dominance), for the integrated business.

- **Vertical integration** takes place between businesses that are at different stages of production. *Forward vertical integration* is the amalgamation or consolidation of businesses that head towards the final stage of production (towards the consumer), such as a coffee manufacturer acquiring a chain of coffee shops. *Backward vertical integration* means a merger or acquisition of businesses towards an earlier stage of production, such as a coffee manufacturer amalgamating with its supplier of coffee beans. This external growth strategy helps the manufacturer to secure lower costs of raw materials.

- **Lateral integration** refers to M&As between firms that have similar operations but do not directly compete with each other. For example, Tata Motors (considered a mass market brand) acquired Jaguar and Land Rover (both considered as luxury brands) in 2008, PepsiCo acquired Quakers Oats Company in 2001, Microsoft bought LinkedIn in 2016 and Meta Platforms (formerly Facebook, Inc.) acquired both Instagram (for a bargain $1bn in 2012) and WhatsApp (for $19bn in 2014).

- **Conglomerate M&As** are the amalgamation of businesses that operate in completely distinct or diversified markets. For example, Berkshire Hathaway owns businesses in a vast range of industries, including insurance, property, clothing, meat products, flight services, home furnishing, news media, confectionery, beverages and carpet making! The company has successfully used M&As as an external growth strategy.

The degree of success of M&As depends on several factors. First, the level of planning involved is crucial. A clear rationale of the benefits of the merger or acquisition must be communicated to key stakeholder groups to gain their support. Success also depends on the aptitudes of senior directors of the companies involved in the M&A. In addition, conflict can easily lead to the demise of M&As. Managers need to exert their negotiation skills and be able to handle the added pressures and responsibilities that they will face. Finally, regulatory problems can also present a barrier to success. The government can step in to prevent M&As taking place in order to prevent the business from having too much market power, if this is deemed to be against the best interest of the general public.

Table 5.5 - The benefits and drawbacks of mergers and acquisitions

Benefits of M&As	Drawbacks of M&As
Greater market share - The integrated company is likely to benefit from having greater market power, higher sales revenues and a larger customer base.	**Redundancies** - Job losses are likely to occur due to cost savings in M&As. For example, the new company will not need two finance or marketing directors.
Economies of scale - Operating on a larger scale helps to lower unit costs of production, thus improving the firm's competitiveness and/or profit margins.	**Conflict** - There are likely to be disputes and differences between the companies involved, so conflict is inevitable even if they eventually agree to the M&A.
Synergy - The integrating firms have access to each other's resources, such as distribution channels, technologies, human resources and management expertise. Hence, they are able to make use of their combined resources to increase productivity, sales revenues and profits.	**Culture clash** - People will need to adapt to the desired corporate culture of the newly formed organization. The M&A, as a new entity, might also entail changes to the company's core values and mission statement. Staff might also need time to adapt to new methods of working.
Survival - M&As are a quick method of growth to protect the survival of a business. As a defensive strategy, it allows the new firm to be in a stronger position to compete with its rivals.	**Loss of control** - The original owners or Board of Directors will lose some degree of control as the new Board will need to be restructured, including the creation of a new management team.
Diversification - Some M&As allow firms to diversify their product mix. This allows them to spread and reduce risks as well as benefit from a larger customer base.	**Diseconomies of scale** - The larger firm might suffer from increased bureaucracy and longer channels of communication, leading to less effective decision-making.
Gain entry into new markets - This can be achieved if the companies involved in the M&A currently operate in different markets.	**Regulatory problems** - Governments may be concerned with and hence prevent, M&As if they create a monopoly with too much market power.

Question 5.5 - The London taxi

In 2013, the producers of the iconic black taxi, London Taxi International (LTI), was sold to China's largest carmaker Geely for just £11.4m ($16m). LTI went into administration in October 2012 after five consecutive years without making any **profit**, with most of its workers losing their jobs.



The **acquisition** safeguarded production in the UK to secure the British association of the London black taxi as a global brand, although *Geely's* factory in Shanghai focuses on building taxis for the left-hand drive market. In a rare move following an acquisition, Geely rehired the workers who were made redundant following LTI's successive losses between 2007 to 2012. LTI was re-branded as the London Electric Vehicle Company in 2017.

(a) Define the term *profit* *[2 marks]*

(b) Define the term *acquisition*. *[2 marks]*

(c) Explain the winners and losers from Geely's acquisition of LTI. [6 marks]

(d) Discuss the driving forces behind Geely's strategic move to acquire LTI. *[10 marks]*

ATL Activity 5.1 (Research skills)

Investigate recent mergers and acquisitions in your country, or a country of your choice. Who were the winners and losers?

Business Management Toolkit

What is the significance of understanding Hofstede's cultural dimensions (see Chapter 54) for the success of international mergers and acquisitions?

(ii) Takeovers

In contrast to acquisitions, **takeovers** occur when a company purchases a controlling stake (majority of the stocks) in another company without the permission and agreement of the company or its Board of Directors. Hence, takeovers are also referred to as **hostile takeovers**.

To entice shareholders of the target company to sell their shares, the offer price for the takeover is likely to be well above the stock market value of the shares.

Takeovers have been used as a method of business growth for a long time. For example, Heineken, the Dutch beer company established in 1864 by Gerard Adriaan Heineken, came to dominate the Dutch brewing industry by taking over many of its competitors. With over 195 years of history, Cadbury was taken over by Kraft Foods in 2010 for a whopping $18 billion; reasonable perhaps considering people spend over $9.5 million on chocolates per hour! In 2017, 21st Century Fox was bought by the Walt Disney Company for $52.4 billion. Box 5.1outlines the main reasons why a certain business might become a takeover target.

Box 5.1 - Reasons why businesses become takeover targets

- They have growth potential but lack sufficient funds for internal growth.
- They are seen as a small rival that has growth potential.
- They have a widely recognised corporate name or brand but currently face a liquidity or financial crisis.
- They are vulnerable (an easy target for a takeover) due to a drop in profits and subsequent fall in their share price.

Key concept

Can hostile takeovers ever be judged as **ethical** business behaviour?

Question 5.6 - Disney's takeover of Pixar and Lucasfilm

In 2006, The Walt Disney Company (or Disney for short) paid $7.4 billion in a deal to take ownership of Pixar Animation Studios, the firm responsible for movies such as Toy Story, Finding Nemo, Cars and Monsters Inc. Disney said that high demand for Pixar's movie merchandise (such as Buzz Lightyear toys and DVD movie sales) had earned Disney over $3.2 billion.

The real value to Disney's **takeover** of Pixar, however, is the **synergy** that would be created from the integration of the two firms. In 2010, Toy Story 3 became the highest-grossing animated movie of all time, earning over $1bn at the box office. As part of its growth strategy, Disney also acquired Lucasfilm in 2012 and scheduled production of a third trilogy of *Star Wars*, with Episode VII released in December 2015 and Episode IX in December 2019.

(a) Define the term *acquisition*. *[2 marks]*

(b) Define the term *synergy*. *[2 marks]*

(c) Explain **two** potential problems for businesses during an acquisition. *[6 marks]*

(d) Discuss the decision of The Walt Disney Company to acquire other firms such as Pixar and Lucasfilm *[10 marks]*

(iii) Joint ventures

A **joint venture** (JV) occurs when two or more businesses split the costs, risks, control and rewards of a project. In doing so, the parties agree to set up a new legal business entity. For example, Coca-Cola has a JV with San Miguel by shared ownership of Coca-Cola's bottling plant in the Philippines. Since 2003, the German carmaker BMW has had a joint venture with Brilliance Auto in the production, distribution and sale of BMW passenger cars in China. Typically, a JV between two firms will involve a 50:50 split of costs, responsibilities and profits (or losses).

Joint ventures allow organizations to enjoy similar benefits to mergers and acquisitions but without having to lose their individual corporate identities. The advantages of joint ventures include:

- **Synergy** - The pooling of experiences, skills and resources of the collaborating firms in the JV should create synergies. For example, the 50:50 joint venture between Bank of Scotland and Sainsbury's (a commercial bank and a supermarket chain) between 1997 and 2014 meant that

both parties could specialize in their area of expertise yet gain access to new technologies and customers to achieve larger profits for both organizations.

- **Spreading of costs and risks** - Financial costs, risks and losses are shared in a JV thereby helping to reduce the financial burden on any single organization. JVs also allow firms to diversify their products, thereby helping to spread the risks associated with growth and evolution.

- **Entry to foreign markets** - Joint ventures are used by companies to enter foreign countries by forming an agreement with local firms. In some cases, national laws make JVs the only option for businesses wishing to enter foreign markets. For example, many foreign companies have entered China and India by creating JVs with local Chinese and Indian businesses.

- **Relatively cheap** - Mergers and acquisitions can be highly expensive as they entail lengthy legal procedures and administrative costs. The cost of a hostile takeover is often unknown. By contrast, JVs are cheaper to establish and are easier to pull out of should this be necessary.

- **Competitive advantages** - Competition is reduced by forming a JV. Companies cooperating in a JV are unlikely to directly compete with each other, yet their pooled resources make them a stronger force against their rivals. Their combined size could also mean that further economies of scale can be enjoyed.

- **Exploitation of local knowledge** - Firms that expand via international JVs can take advantage of each other's local knowledge and reputation. This might not be the case with mergers or acquisitions that are exposed to potential problems of overseas expansion (such as differences in business etiquette, cultural values, languages and local traditions).

- **High success rate** - Joint ventures tend to be friendly and well received by key stakeholder groups. The parties pool their funds and resources, sharing responsibility for their mutual benefit. This positive attitude is more likely to lead to the success of a JV. By contrast, takeovers often fail due to their aggressive and hostile nature.

Joint ventures and strategic alliances (see below) have similar drawbacks. Partners in a JV have to rely heavily on the resources and goodwill of their counterparts. There is also likely to be a dilution of the brands, yet firms spend huge amounts of money trying to develop their own brands (see Chapter 27). Finally, whenever companies work together on a project, there is always the possibility of organizational culture clashes that can lead to operational problems and conflicts for the joint venture.

Question 5.7 - Tiffany & Co. and Swatch Group

In 2007, Swatch struck a **joint venture** deal with jewellery chain Tiffany & Co to make watches together under the brand Tiffany Watch Co. The contract was to last 20 years, giving Swatch the rights to sell watches under the new brand name in Tiffany's retail outlets and other high-end outlets.

However, disputes between the two companies started in 2011 which resulted in Swatch, the world's largest watchmaker, cancelling the collaboration. Swatch had accused Tiffany of blocking the development of their business, having already invested millions of dollars to develop the watches. In 2014, Tiffany & Co. was ordered by the authorities to pay Swatch Group almost $450m in the failed joint venture as well as $9m to cover the legal fees for Swatch.

(a) Define the term *joint venture.* *[2 marks]*

(b) Explain **two** reasons why a merger between Tiffany & Co. and Swatch might not have been appropriate compared to the joint venture. *[4 marks]*

(c) Examine the costs and benefits of the joint venture to Tiffany & Co. and Swatch *[6 marks]*

(iv) Strategic alliances

A **strategic alliance** (SA) is similar to a joint venture in that two or more businesses cooperate in a business venture for mutual benefit. The firms in the SA also share the costs of product development, operations and marketing. However, unlike JVs, forming a strategic alliance means that the affiliated businesses remain independent organizations and do not form a new legal business entity. Typically, there are four key stages to the formation of a strategic alliance:

1. *Feasibility study* - Investigate and establish the rationale, objectives and feasibility of the SA.

2. *Partnership assessment* - Analyse the potential of different partners for the SA, such as what they have to offer to the coalition in terms of both human and financial resources as well as their skills, experiences and areas of expertise.

3. *Contract negotiations* - Discussions take place to determine each member's contributions and rewards, thus forming a mutually acceptable contract.

4. *Implementation* - Operations are initiated with commitment to the contract from all parties involved in the newly created SA.



Figure 5.7 - Strategic alliances are common in the airline industry

The main purpose of a strategic alliance is to gain synergies from the different strengths of each member of the consortium by pooling their resources (to gain from each other's areas of expertise as well as financial support). Two airlines both with half-empty aeroplanes could directly compete or they could collaborate by using a single full aeroplane to cut the costs of airline crew and fuel costs, choosing instead to split the profits for mutual benefit. Strategic alliances also enable members to gain from economies of scale by operating on a larger scale. Furthermore, customers are likely to benefit from the value-added services under a strategic alliance, such as the convenience of access to wider channels of distribution (see Chapter 30).

Case study 5.7 - Star Alliance

Star Alliance was set up in 1997 by five founding airlines: Lufthansa, Scandinavian Airlines, Thai Airways International, United Airlines and Air Canada to share the costs and benefits of airline operations. Its headquarters are located in Frankfurt, Germany.

It was the first ever strategic airline alliance and has grown to 26 members, making it the largest alliance in the industry with a pre-pandemic (COVID-19) passenger count of 762.27 million. The alliance also includes 40 non-voting affiliated airline carriers, which enables the alliance to serve almost every country on the planet.

Business Management Toolkit

What is the significance of cultural dimensions for international takeovers, joint ventures and strategic alliances?

You may find reference to Chapter 54 (Hofstede's cultural dimensions) useful prior to answering this question.

(v) Franchising

McDonald's, Subway, The Body Shop and many others use **franchising** as a method of external growth. A franchise is a form of business ownership whereby an individual or business buys a license to trade using another company's products, name, logos, brands and trademarks. In return for this benefit, the purchaser of a franchise (called the **franchisee**) pays a license fee to the parent company (known as the **franchisor**). The franchisee also pays a **royalty payment** (similar to commission) based on the sales revenue of the franchisee.

The world's largest franchises include 7-Eleven, Baskin-Robbins, Burger King, Hertz, InterContinental Hotels, KFC, Marriot International, McDonald's, Pizza Hut and Subway. The benefits and drawbacks of franchising for franchisors and franchisees are outlined in Tables 5.6 and 5.7.

Case study 5.8 - Burger King

Burger King has used franchising as its key business strategy for growing nationally and internationally. The world's second largest fast-food chain has more than 18,000 outlets, with around 90% of them being franchises.

Its high success rate relies on the know-how, brand recognition and trust of a parent organization coupled with the incentives and enthusiasm of the franchisees to make it a success. Burger King's parent company is *Restaurant Brands International Inc*, which also owns Tim Hortons and Popeyes.

Table 5.6 - The benefits of franchising for franchisors and franchisees

Benefits for the franchisor	Benefits for the franchisee
The company can experience rapid growth without having to risk large amounts of money as the franchisee pays for the rights. Hence, it can be cheaper and faster than internal growth.	There are relatively lower start-up costs because the business idea has already been developed by the franchisor (such as market research, brand development and product development strategies).
It allows the company to have a national or international presence without the higher costs of internal growth or M&As (as the franchisee helps to finance the expansion).	There is relatively low risk because the franchisor has a tried and tested formula, so the chances of business success are statistically high.
The franchisor benefits from rapid growth without having to worry about running costs such as recruitment, training and development, staff salaries and the purchase of stocks (inventories).	It is in the best interest of the franchisor to ensure that the franchise succeeds, so it will provide value-added services to support the franchisee, such as training and advice on financial management.
Franchisors receive royalty payments from the franchisee, usually set as a percentage of the sales revenues. They also usually charge franchisees a 'membership' (registration or joining) fee.	The franchisee is likely to benefit from large scale advertising used by the franchisor, i.e. franchisees receive 'free' advertising and promotion, which also helps to reduce their costs.
Franchisees have more incentives to do better than salaried managers, thereby increasing the chances of success for the franchisor.	Franchisees are still, technically, their own bosses, so have a large degree of autonomy in running their own business, within the parameters of the agreement.

Table 5.7 - The drawbacks of franchising for franchisors and franchisees

Drawbacks for the franchisor	Drawbacks for the franchisee
There is a huge risk in allowing other parties (franchisees) to use the franchisor's name. Unsuccessful franchisees can damage the reputation of the entire franchise business.	Franchisees cannot simply use their own initiative to try out new ideas as they are overseen by the franchisor and the formal agreement. This could hinder the entrepreneurial talents of the franchisee.
It can be difficult to control the daily operations of all franchisees and to get them to meet the quality standards set by the franchisor.	Buying a franchise can be very expensive, yet there is no guarantee that this investment will ever be recouped.
Although franchising is faster than internal growth methods, it is not as quick as other external methods such as M&As.	Franchisees have to pay a significant percentage of their sales revenues to the franchisor.

Question 5.8 - Pizza Hut

Founded in 1958, Pizza Hut is the world's largest chain of pizza restaurants. Within a year of opening, the company launched its first **franchise**. Today, its operations span the globe with over 18,700 restaurants in over 95 countries. The company plans to continue opening more stores in existing and new locations. The company has a dedicated website with everything potential franchisees need to know about becoming a Pizza Hut franchisee.

(a) Define the term *franchise.* *[2 marks]*

(b) Explain **two** reasons for Pizza Hut's decision to use franchising as its main method of growth. *[4 marks]*

(c) Examine the potential problems of Pizza Hut's growth strategy. *[6 marks]*

Exam tip !

Make sure you are able to evaluate the different methods of external growth. A strategy that is suitable for one organization is not necessarily appropriate for others. It is important to put your answers in the context of the business and to consider short- and long-term factors in your evaluation. Reference to Hofstede's cultural dimensions (see Chapter 54) could also be relevant when evaluating growth methods that involve overseas partners.

Growth and evolution and the key concepts

Growth is a strategic objective for many businesses. In an ever-integrated business world, the driving force behind growth and evolution is not simply profit, but sustainable competitiveness - as the Chinese proverb goes "*Be not afraid of going slowly; be afraid only of standing still.*"

Mergers and acquisitions (see Chapter 5) are common in today's fast-paced, highly competitive and continually changing business environment. Organizations are increasingly having to 'run faster to stay still', i.e. they have to change and be creative in order to grow and evolve in a sustainable way. This is vital for any business striving to maintain its market share and competitiveness.

Growth and evolution do not always work out, so businesses might strategically choose to shrink in size. This might involve breaking away from a strategic alliance, terminating a joint venture or demerging. Reasons for doing so include:

- Offloading unprofitable sections of the business.
- Avoiding rising average costs and inefficiencies by being too large (caused by internal and external diseconomies of scale).
- Raising cash to sustain operations in other parts of the business that are more profitable.
- Having a clearer corporate focus by concentrating efforts on a smaller range of products or business operations.



Figure 5.8 - Demergers are not uncommon in the business world

For some businesses, growth and downsizing can occur on a cyclical basis. Reductions in the size of a business generate their own problems that need careful change management. For example, there is likely to be a reduction in staffing, so redundancies have to be planned and managed sensitively and ethically. For larger organizations, the costs of staff redundancies can be quite considerable and cause short-term liquidity problems for the business (see Chapter 20).

Key concept

With reference to an organization of your choice, examine how **creativity** has influenced its growth strategy.

Key concept

With reference to a business of your choice, examine how **change** has influenced its evolution as an organization.

Key concept

With reference to an organization of your choice, examine how **creativity** affects its ability to **change** and evolve.

Exam tip !

To broaden your understanding of the complexities that businesses face when operating in overseas markets, read Chapters 6 (multinational companies) and Chapter 46 about the external environment (STEEPLE analysis). Make connections between the contents in this chapter and that in Chapters 6 and 46, with consideration of how the political, legal and social environments affect a firm's growth strategies.

REVIEW QUESTIONS

1. What is the meaning of economies of scale?
2. What is average cost and how is it calculated?
3. What are diseconomies of scale?
4. How might the notion of economies and diseconomies of scale be shown on a diagram?
5. What is meant by the optimal size of a business?
6. What are the main types of internal economies of scale?
7. What are the main types of external economies of scale?
8. How do internal diseconomies of scale differ from external diseconomies of scale?
9. How does internal growth differ from external growth?
10. What are the main reasons why businesses seek to grow?
11. What are the main reasons why some businesses stay small?
12. What are mergers and acquisitions?
13. What is a takeover?
14. How do joint ventures differ from strategic alliances?
15. What are the advantages and disadvantages of franchising as a method of external growth?

KEY TERMS

An **acquisition** is a method of external growth that involves one company buying a controlling interest (majority stake) in another company, with the agreement and approval of the target company's Board of Directors.

Average cost refers to the cost per unit of output.

Backward vertical integration occurs when a business amalgamates with a firm operating in an earlier stage of production, such as a car manufacturer taking over a supplier of tyres or other components.

Conglomerates are businesses that provide a diversified range of products and operate in a range of different industries.

A **demerger** occurs when a company sells off a part of its business, thereby separating into two or more businesses. It usually happens due to conflicts, inefficiencies and incompatibilities following an earlier merger of two or more companies.

Diseconomies of scale are the cost disadvantages of growth. Average costs are likely to eventually rise as a firm grows due to a lack of control, coordination and communication.

Economies of scale refer to lower average costs of production as a firm operates on a larger scale due to gains in productive efficiency, such as easier and cheaper access to source of finance.

External diseconomies of scale occur due to factors beyond its control which cause average costs of production to increase as an industry grows.

External economies of scale occur when an organization's average cost falls as the industry grows. Hence, all firms in the industry benefit.

External growth (or **inorganic growth**) occurs when a business grows and evolves by collaborating with, buying up or merging with other organizations.

Financial economies of scale are cost savings made by large firms as banks and other lenders charge lower interest (for overdrafts, loans and mortgages) because larger businesses represent lower risk.

Forward vertical integration is a growth strategy that occurs with the amalgamation of a firm operating at a later stage in the production process, such as a book publisher acquiring book retailers.

Franchising refers to an agreement between a franchisor selling its rights to other businesses (franchisees) to allow them to sell products under its corporate name in return for a fee and regular royalty payments.

Horizontal integration is an external growth strategy that occurs when a business amalgamates with a firm operating in the same stage of production.

Internal diseconomies of scale occur due to internal problems of mismanagement, causing average costs of production to increase as a firm grows.

Internal economies of scale occur within a particular organization (rather than the industry as a whole) as it grows in size.

Internal growth (also known as **organic growth**) occurs when a business grows using its own capabilities and resources to increase the scale of its operations and sales revenue.

A **joint venture** is a growth strategy that combines the contributions and responsibilities of two or more different organizations in a shared project by creating a separate legal enterprise.

Lateral integration refers to external growth of firms that have similar operations but do not directly compete with each other, such as PepsiCo acquiring Quakers Oats Company.

Marketing economies of scale occur when larger businesses can afford to hire specialist managers, thereby improving the organization's overall efficiency and productivity.

A **merger** is a form of external growth whereby two (or more) firms agree to form a new organization, thereby losing their original identities.

The **optimal level of output** is the most efficient scale of operation for a business. This occurs at the level of output where the average cost of production is minimized.

The **purchaser** refers to the acquiring company in an acquisition or the buyer of another company in a takeover.

Purchasing economies of scale occur when larger organizations can gain huge cost savings per unit by purchasing vast quantities of stocks (raw materials, components, semi-finished goods and/or finished goods).

Risk bearing economies of scale occur when large firms can bear greater risks than smaller ones due to having a greater product portfolio.

Specialization economies of scale occur when larger firms can afford to hire and train specialist workers, thus helping to boost their level of output, productivity and efficiency.

Strategic alliances are formed when two or more organizations join together to benefit from external growth, without having to set up a new separate legal entity.

Synergy is a benefit of growth, which occurs when the whole is greater than the sum of the individual parts when two or more business operations are combined. Synergy creates greater output and improved efficiency.

A **takeover** (also referred to as **hostile takeover**) occurs when a company buys a controlling interest in another firm without the prior agreement or approval of the target company's Board of Directors.

The **target company** refers to the organization that is purchased by another in an acquisition or takeover deal.

Technical economies of scale are cost savings by greater use of large-scale mechanical processes and specialist machinery, such as mass production techniques which help to cut average costs of production.

Vertical integration takes place between businesses that are at different stages of production.

Chapter 6

Unit 1.6 - Multinational companies (MNCs)

"Growth demands a temporary surrender of security."
- Gail Sheehy (1936 - 2020), American author, journalist and academic

Contents

1.6 Multinational companies (MNCs)	
SL/HL content	**Depth of teaching**
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The impact of MNCs on the host countries (AO3)

A **multinational company** (MNC) is an organization that operates in two or more countries, usually with its head office (or headquarters) based in the home country. The terms MNC and **transnational corporation** are often used interchangeably, although some commentators say that a MNC has its head office based in the home country whereas a transnational corporation has regional head offices rather than a single international base. Examples of large MNCs include Apple, Coca-Cola, Louis Vuitton, Nike, Samsung and Toyota, which all stand out within their industries in terms of sales revenue, profits, capital assets and market value.

The rise of MNCs and the ever-growing importance of international trade have intensified globalization. Businesses may strive to become MNCs for several reasons, including the following:

- An **increased customer base** by expanding internationally allows businesses to benefit from higher sales revenue. For example, many businesses (such as KFC, Starbucks, Lamborghini and Walmart) have expanded into China to benefit from the huge customer base.
- Many MNCs expand overseas to benefit from **cheaper production costs**, especially inexpensive labour. For example, the relatively high cost of labour in Germany, partly due to the imposition of minimum wage legislation, has meant that businesses such as Adidas, BMW and Volkswagen have production facilities overseas with access to readily available labour at a more affordable cost.
- As production levels increase, MNCs are able to benefit from **economies of scale** (see Chapter 5). MNCs might also want to locate overseas to benefit from the host country's infrastructure, such as its network of roads, telecommunications and ports. The host country may offer better quantity and quality of land in terms of the amount of space and/or the cost of land. There could also be financial incentives from the host country's government which help to reduce average production costs whilst allowing the MNC to expand into new markets.
- **Brand development** and **brand value** can be enhanced by operating on an international scale. Brand recognition and brand loyalty can also be enhanced by using global marketing strategies. The importance of branding is covered in Chapter 27).

- By producing within a particular country, MNCs can usually avoid any **protectionist policies** that the country might impose (see Box 6.1). This is one reason why many Japanese motor vehicle manufacturers, including Toyota, Honda and Nissan, have established factories in the European Union and North America.

- MNCs are able to **spread risks**. This means that unfavourable market conditions in one country or region of the world might not damage the overall business if it can spread risks internationally. Natural disasters (such as tsunamis), terrorist acts (such as the 9-11 attacks) and diseases (such as swine flu and mad cow disease) have affected different parts of the world. Over-specialization in any one of these regions could have led to a serious reduction in profits for these businesses.

Box 6.1 - Protectionist policies (trade barriers)

- **Tariffs** are a tax on imports, thereby adding to the price of foreign products. This makes imports less price competitive. MNCs can overcome this by establishing production facilities in the tariff-imposing nation.

- **Quotas** are quantitative limits imposed on the sale of imports. This results in a lower supply (or availability) of imported products, thereby forcing up import prices.

- **Restrictive trade practices** are acts that unfairly, although not illegally, discriminate against foreign firms as they do not apply to domestic firms. Examples include rigorous administrative procedures and strict safety standards imposed on imports

The impact of MNCs on the host countries (AO3)

A **host country** is any nation that allows a multinational company to set up in its country. In addition to the reasons for the growth of MNCs (see above), they have varying impacts on host countries, some of which are beneficial whilst others are detrimental.

The positive impacts of MNCs on host countries include:

- **Job creation** - MNCs create job opportunities in the host country. For example, Volkswagen's manufacturing plant in Kaluga, Russia created over 3,500 jobs with an initial investment of $400 million. Although some MNCs have been criticised for paying 'low' wages to workers in poorer countries, MNCs typically offer higher pay than local firms in these countries.

- **Higher national income** - MNCs help to increase the host country's gross domestic product (GDP). This is the value of a country's annual output or national income by creating consumption expenditure (as more workers are in paid employment) and by boosting export earnings for the host country, which also improves the nation's average standard of living. For example, one of Hungary's largest exporters is German car manufacturer Audi, which has its Audi TT sports car produced in western Hungary.

- **Knowledge and technology transfer** - MNCs have introduced new skills and technologies in production processes to host countries. For example, Japanese firms have introduced lean production and quality management models such as kaizen, just-in-time, quality circles and total quality management (see Chapter 37) to other economies. With new ideas in strategic management thinking and technology transfer, the efficiency of production in the host country is raised. This also helps to improve the international competitiveness of businesses in the host country.

- **Increased competition** - MNCs intensify the degree of competition in the host country. This should lead to greater efficiency gains to the benefit of domestic customers. Also, it can be argued that without the threat or presence of MNCs, domestic firms do not necessarily have the incentive to be as creative or innovative in responding to changes in the economy.

The interrelated negative impacts of MNCs on host countries include:

- **Job losses** - Just as they are able to create jobs, MNCs are capable of causing unemployment in the host country too. This is because MNCs are likely to pose a threat to domestic businesses. Competition can be beneficial if it causes domestic firms to improve their efficiency and productivity, but it can also be a setback if it means that local firms are

unable to compete and end up making people redundant or even having to close down.

- **Repatriation of profits** - Whilst MNCs can create wealth in a host country, the profits of the company are repatriated to the home country. This can have a negative effect on the host country's tax revenues and on the size and the frequency of foreign direct investment (FDI) as the profits do not remain in the host country.

- **Vulnerability** - There is a degree of insecurity as MNCs are increasingly footloose (see Chapter 38). This means they are not bound to a specific location so can change at very short notice for cost advantages. For example, in 2012 French retailing giant Carrefour pulled out of Turkey, Poland, Romania, Malaysia, Indonesia and Singapore.

- **Social responsibilities** - Anti-globalization groups are concerned about the social responsibility of MNCs in their attempt to grow and exploit the planet's scarce resources. Host nations are often unable to control the actions of large MNCs, due to their sheer market power. For example, Walmart's sales revenues exceed the GDP of Nigeria and Pakistan, two of the world's most populous countries. Such market power can be challenged, especially if a MNC does little to support the local communities in which it operates.

- **Competitive pressures** - Due to fierce competition, domestic firms might be forced into reducing prices to remain competitive. Knowledge and technology transfer might also present a further threat as domestic businesses might not have the finances or resources to compete with large MNCs, so they become prone to takeover bids (see Chapter 5) or collapse outright.

Business Management Toolkit

Discuss the opportunities and threats (see Chapter 44) that a multinational company of your choice presents to a host country of your choice.

Theory of Knowledge (TOK)

Globalization has been blamed for causing the loss of cultural identities. Does this diminish our breadth of knowledge?

Key concept

To what extent does the threat or presence of MNCs encourage **creativity** in the host country?

Case study 6.1 - Hollywood



Hollywood, a name that has become synonymous with the US film industry, is a threat to many movie industries around the world. Governments often intervene to protect their domestic industries and jobs from foreign competition. For example, China and India limit the number of Hollywood movies that are released each month in their respective countries. China has an official annual quota of 34 foreign movies whilst India is the largest producer of movies in the world.

Question 6.1 - The Coca-Cola Company

Founded in 1886, the Coca-Cola is the largest beverages company in the world with a workforce of 86,200 employees and annual sales revenue of over $37.3bn (or around $102.2 million each day). Its drinks are sold in more than 200 economies and its iconic Coca-Cola brand is recognized instantly around the world. According to its website, more than 10,000 soft drinks from the Coca-Cola Company are consumed every second of every day (that's more than 1.9 billion drinks per day).

The American soft drinks company has a long-established market presence in many countries, giving it a competitive advantage albeit in a mature market. **Brand awareness** and **brand loyalty** have been secured by its sponsorship of prominent sporting events such as the Olympic Games, NASCAR, the PGA Tour, English Premier League, the UEFA European Championships and the FIFA World Cup. The company also has exclusive sponsorship rights as the beverage provider in many major theme parks including the Walt Disney Parks and Resorts, Universal Parks & Resorts, SeaWorld Entertainment and Merlin Entertainment.

Source: adapted from https://www.coca-colacompany.com/

(a) Outline the evidence that suggests the Coca-Cola Company is a multinational business. *[2 marks]*

(b) Distinguish between *brand awareness* and *brand loyalty*. *[4 marks]*

(c) Explain **two** factors that may have led to the globalization of the soft drinks market. *[4 marks]*

(d) Discuss the possible opportunities and threats to the Coca-Cola Company operating in overseas markets *[10 marks]*

Question 6.2 - MNCs in the UAE

Multinational companies are attracted to the United Arab Emirates (UAE) because of the low taxes, political stability and high gross domestic product (GDP) per capita. Microsoft, Marriott Group, DHL and Ericsson all have operations in the UAE. The influx of engineering, law and accountancy firms brings managers from many countries and creates a demand for goods and services. The UAE does not have any federal income tax and there is also a 0% corporate tax rate.



Dubai (one of the seven Emirates that make up the UAE) has gained a reputation as being a destination for shopping, attracting many tourists from around the world. Dubai is the largest and most populous city in the UAE, with over 3.46 million people. It is one of the world's fastest growing economies.

(a) Define the term *multinational companies.* *[2 marks]*

(b) Explain how change might affect the location of multinational companies. *[4 marks]*

(c) Examine the benefits to multinational companies operating in foreign countries such as the UAE. *[6 marks]*

ATL Activity 4.2 (Thinking skills)

How do multinational companies market their products to different cultures? As a starting point, you can watch this short video on the comparative marketing approaches of McDonald's in China and the USA: shorturl.at/fiqGX

Consider the different reasons why McDonald's might offer different variations of the same products (such as chicken nuggets and French fries) in different countries.

Theory of Knowledge (TOK)

Do China and India present the most important competitive threat or opportunity for global brands and multinational companies?

Multinational companies and the key concepts

The concepts of change, ethics, creativity and sustainability are central to any business strategy that involves growth in overseas markets. International trade can cause major problems including adjusting to foreign customs and cultures. Hence, there may be a need to change business practices in a creative and ethical way to suit local laws and regulations. In addition, an understanding of cultural dimensions (see Chapter 54) can be highly beneficial for businesses operating in overseas markets.

However, change is not always sustainable. Growth through international mergers and acquisitions or strategic alliances (see Chapter 5) do not always work due to resistance to change and cultural clashes. In such cases, a **demerger** might take place. This happens when a company sells off a part of its business, thereby separating into two or more business entities. It usually happens due to cultural conflicts, inefficiencies and incompatibilities. For example, Cadbury Schweppes (which merged back in 1969) split up in 2008. Global car manufacturer DaimlerChrysler (which merged in 1998) demerged in 2007.

An alternative strategy to a complete merger or takeover for MNCs is to buy one of the brands of the target company. This strategy is known as **brand acquisition**. For example, BMW bought the Rolls Royce brand in 2003 to enhance and sustain its broad and balanced product portfolio (see Chapters 27 and 47). This is a relatively low risk growth strategy but can be expensive. For example, in 2013, Berkshire Hathaway bought the Heinz brand for $28 billion. Similarly, a firm might decide to sell off one of its brands if it is facing a liquidity problem (see Chapter 20), rather than be acquired by a third-party company which would cause more disruptive change to the organization.

Business Management Toolkit

How might knowledge of Hofstede's cultural dimensions (see Chapter 54) be of significance for multinational companies and their operations in overseas markets?

Key concept

Discuss the extent to which large and profitable multinational companies should have an **ethical** obligation to support low-income members of society.

Key concept

How might the activities of multinational companies cause positive and negative **change** to host countries.

Theory of Knowledge (TOK)

Given different cultural dimensions that exist, how can we know whether the presence of MNCs in host countries act in an ethical way?

Question 6.3 - Bollywood

Bollywood is the Hindi-language film industry - the largest in India, with billions of viewers worldwide. Since 2000, Bollywood has grown in popularity around the world as globalization and digital media make access to information much easier and faster. Bollywood movies are typically more than three hours long, with dozens of flamboyant songs and dances and always feature a happy ending. India is a country of 16 official languages although 24 languages are spoken by over a million people each. Indian cinema is the world's largest film industry as measured by ticket **sale revenue** and film production.

Katrina Kaif is a one of Bollywood's highest-paid actresses. She was born in Hong Kong in 1983, but soon moved to China and then to Japan. By the time she was 8, she had moved to France and then onto Switzerland, Poland, Germany, Belgium, Hawaii and England. Her career eventually took her to Mumbai. As a British-Indian actress and hugely popular movie star, Katrina Kaif was honoured with a wax figure at Madame Tussauds in London in 2015.

(a) Define the term *sales revenue.* *[2 marks]*

(b) Discuss the view that knowledge and awareness of local cultures are important aspects of successful multinational companies. *[10 marks]*

CORE

Exam tip !

To broaden your understanding of the complexities that multinational companies face when operating in overseas markets, refer to Chapter 46 (STEEPLE analysis). Make links between this business management tool and the contents in this chapter, such as how the political, legal and social environments affect a MNC's growth strategy.

REVIEW QUESTIONS

1. What is a multinational company (MNC)?
2. What are the main reasons why many businesses strive to become MNCs?
3. What are trade protectionist policies?
4. What positive impacts do multinational companies have on host countries?
5. What negative impacts do multinational companies have on host countries?

KEY TERMS

Gross domestic product (GDP) is the value of a country's annual output or national income.

A **host country** is any nation that allows a multinational company to set up in its country.

A **multinational company** (MNC) is an organization that operates in two or more countries, with its head office usually based in the home country.

Protectionist policies are measures imposed by a country to reduce the competitiveness of imports, such as tariffs (import taxes), quotas and restrictive trade practices.

Chapter 7

Unit 2.1 - Introduction to human resource management

"A thousand workers, a thousand plans."
- Chinese Proverb

Contents

2.1 Introduction to human resource management	
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Reasons for resistance to change in the workplace	AO2
Human resource strategies for reducing the impact of change and resistance to change	AO3

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CORE

Role of human resource management (AO2)

Human resource management (HRM) is the management function of deploying and developing people within an organization to meet its business objectives. This entails interrelated roles, such as:

- Human resource planning (also known as workforce planning)
- The recruitment, selection and induction of new employees
- Training and development of employees
- Performance management and staff appraisals
- Reviewing pay and remuneration packages
- Disciplinary, grievance and disciplinary procedures
- Looking after the welfare (wellbeing) of employees.

Human resources are important to an organization as they add value to its output (see Chapter 1). This can be achieved by increasing labour productivity (output per worker), improving product quality, creating new ideas and providing better customer service to enhance the overall purchasing experience of customers. Consider, for example, the differences in your experience as a student with and without an experienced and dedicated classroom teacher.

Many entrepreneurs argue that human resources are an organization's most valuable resource. Employing the right people helps businesses to achieve their organizational objectives. To do this, a firm needs to use **human resource planning** (or **workforce planning**) - the management process of anticipating and meeting an organization's current and future staffing needs. The workforce refers to the number of employees

in an organization at any one point in time. Workforce planning can be short term or long term, although it is an ongoing process for most businesses:

- Short term human resource planning deals with the existing and upcoming demands of an organization, such as employing workers to replace staff who are due to resign, retire or go on maternity or paternity leave.

- Long term workforce planning looks at the human resource needs of the business in the foreseeable future. For example, the Walt Disney Company recruited and trained employees up to two years before Hong Kong Disneyland was opened.

Human resource planning can be achieved by looking at:

- *Historical data and trends* - This could include data about the changes in the size of the workforce over the past few years or the proportion of staff on part-time contracts or flexible working hours. However, past data and trends are not necessarily indicative of what will actually happen in the future.

- *Sales and income levels* - Higher levels of income and spending in the economy will lead to more jobs being created.

- *Labour turnover rates* - These measure the number of employees who leave a firm as a percentage of its workforce, per year (see Chapter 10). The higher the staff turnover rate, the more workers a firm will need to recruit and train.

- *The flexibility and workload of employees* - A highly flexible and skilled workforce may be able to cope if there is a sudden shortage of staff. In a firm where people are over-specialised and where workload is mounting, it might be more appropriate to employ more people.

- *Demographic changes* - Government data regarding changes in the demographics of the workforce, such as the changes in the number of female workers in the economy or the number of graduates, can help managers to forecast their human resource needs.

Human resource planning consumes a lot of time and money. Market analyses consistently show that poor recruitment practices cost businesses a huge amount of money, resources and time, including the time spent correcting the mistakes made by their staff. For example, a recent report by the *Recruitment and Employment Confederation* showed that for an employee hired in the UK on a salary of £40,000 ($56,000) who left after just 8 months costs the business £132,000 ($185,000) - equivalent to 330% of the salary of that person.



Figure 7.1 - Effective human resource management helps to keep costs down

Nevertheless, human resource planning is an essential role of any business and its strategy. If managers do not make the most of their human resources, the organization will face a number of problems (the 5 Rs):

- *Recruitment* - Higher costs of recruitment, induction and training.

- *Resources* - Increasing amounts of resources and management time spent on dealing with personnel problems, rather than on achieving organizational objectives.

- *Reservations* - Lower morale and higher levels of uncertainty suffered by existing staff who experience continual change mean that employees are more reserved and less productive.

- *Returns* - Lower levels of labour productivity, profits and competitiveness.

- *Reputation* - Poorer corporate image as the business cannot retain or motivate its staff.

Business Management Toolkit

To what extent might the use of STEEPLE analysis (see Chapter 46) be used for strategic human resource planning?

CORE

Human resource management

Internal and external factors that influence human resource planning (AO2)

Internal and external factors that influence human resource planning, for example (i) demographic change, (ii) change in labour mobility, (iii) immigration, (iv) flexitime and (v) gig economy.

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Internal factors (those within the control of the business, such as flexi-time) and external factors (those beyond the control of the business such as immigration) both influence human resource planning.

(i) Demographic change

The supply of human resources in a country is affected by demographic changes in the workforce. Demography is the statistical study of population characteristics and trends. Businesses need to understand these changes so that they can respond appropriately with their human resource strategies. Demographic changes can be caused by changes in various factors, including:

- The *net birth rate* - This is the difference between the number of births and deaths for a given period of time, usually per year. Countries with a high net birth rate will, in the long term, have a larger supply of human resources.
- The *net migration rate* - This measures the difference between the number of people entering a country (immigrants) and the number of people leaving (emigrants). If the net migration figure is positive, the supply of human resources will tend to increase.
- The *retirement age* - This is the legal age when people can stop work and claim money from their pensions. If the retirement age is raised, it automatically increases the number of people in the labour force (those of legal working age). Many economies, faced with an increasing number of elderly people, have increased the retirement age. For example, Germany and Belgium have plans to gradually increase their retirement age to 67 for both men and women by 2029 and 2030 respectively.
- *Females* entering or returning to the workforce - An increase in the female participation rate will boost the supply of human resources in the economy. In many societies, there has been an increase in the number of women working part-time. This gives businesses and staff greater flexibility in determining working hours.

A distinct demographic change in high-income countries is increased longevity, i.e. people, on average, are living longer. Coupled with a declining birth rate in these countries, an **ageing population** (when the average age of the population increases) has the following effects:

- *Increased dependent population* - The dependent population consists of people who are below the legal working age, those out of work and the retired population. They are 'supported' by the working population of taxpayers. With an ageing population, fewer people will be working in proportion to those who have retired, which adds further pressure on taxpayers to contribute towards government expenditure to support the dependent population.
- *Reduced labour mobility* - Younger people tend to be more geographically and occupationally mobile. They have fewer reservations about moving to different places and jobs, including those based overseas. Labour immobility reduces the flexibility and international competitiveness of a country's workforce.
- *Changes in consumption patterns* - Different age groups have different spending patterns. Children, for example, may spend a large proportion of their money (or that of their parents!) on toys and schooling. Retired people are likely to spend a larger proportion of their money on holidays and healthcare related goods and services. Hence, an ageing population can create different opportunities for businesses to cater for more mature age groups.
- *Change in employment patterns* - With more people going to university, the average age of people entering the workforce has also risen. Coupled with an ageing population, this means that businesses are more likely to retain staff beyond their retirement age due to labour supply shortages. Some firms might even consider relocating overseas if domestic labour supply is insufficient or not suitable. Hence, the shortage in labour supply caused by an ageing population will affect workforce planning, recruitment and training.

Question 7.1 - 332 million Americans



In October 2006, the population of the USA reached a new milestone figure of 300 million, making it the third most populated nation on the globe. The last milestone of 200 million people was recorded in November 1967. The population had exceeded 332 million by 2021, with the population increasing by 1 person per 18 seconds. Some people question America's ability to sustain its population growth, given that it is the largest consumer of the planet's scarce resources, despite its **ageing population**. There are also concerns as forecasts show that the population will reach 400 million by 2050.

(a) Define the term *ageing population.* *[2 marks]*

(b) Explain **two** threats created by the demographic changes in the USA. *[4 marks]*

(c) Explain **two** business opportunities provided by the demographic changes in the USA. *[4 marks]*

CORE

Human resource management

(ii) Changes in labour mobility

The **mobility of labour** is the extent to which people can move to different locations (known as *geographical mobility*) and their flexibility in changing to different jobs (known as *occupational mobility*). The more mobile workers are (both geographically and occupationally) the higher the supply of labour tends to be. Labour can be geographically mobile, especially within a country, but there are limitations:

- Friends and family ties tend to be the key constraint for most people's geographical mobility.
- Relocation costs (moving expenses) such as re-mortgaging real estate and consideration of different house prices or the cost of rent.
- Fear of the unknown means that people might prefer 'home comforts' (familiarity). Uncertainties can be daunting for many people, such as uprooting the family and finding new schools for the children.
- The cost of living in particular places, such as the higher cost of housing and other expenses in city districts, can deter people from relocating to these areas, thus limiting the potential supply of labour.
- Language and cultural differences also tend to limit the international mobility of labour (see immigration of labour below).

The degree of occupational mobility will depend on numerous factors, which include:

- Occupational mobility tends to be greater with acquired attributes of a worker (such as educational attainment, qualifications, skills, experience and training).
- As mentioned above, younger people tend to be more occupationally mobile as they often change careers. Mature workers may think they are too 'old' to retrain or may have

more financial commitments so are less willing to take risks by changing careers.

- Some workers are immobile because they are highly specialised in their area of expertise, such as brain surgeons and aircraft pilots. These people may find it more difficult to seek employment opportunities in other industries.

- If employers discriminate against people's age, gender, religion or race then this will also hinder the occupational mobility of workers. Changes in employment laws and the enforcement of anti-discrimination employment practices will therefore improve labour mobility.

Changes in labour mobility have intensified the number of people working in the gig economy (see below). Part-time staff also help to provide more workforce flexibility. In many countries, an increasing number of people work part-time. This is partly due to the greater number of females and full-time students (at university and college) opting to work part-time as well as the benefits of labour flexibility.

A key advantage to a business hiring more part-time staff is that they are cheaper to employ. Part-timers are generally entitled to lower remuneration (pay and benefits) compared with their full-time counterparts and are easier to replace if need be. There is also a large pool of people that can work part-time. This helps to keep wages relatively low and gives businesses greater flexibility. For example, it is easier to adjust working hours to accommodate fluctuations in demand. Hours can be reduced during off-peak periods and raised again during busier times.

However, part-time employees tend to feel less valued and therefore are less loyal to a business. This can negatively affect the level of motivation, productivity and labour retention. Furthermore, a huge amount of time and resources are needed to hire, induct and train new part-time workers. As labour turnover tends to be higher among part-timers, this on-going process can be expensive and uses up a lot of valuable management time. It may therefore be more cost effective for some businesses to hire full-time workers from the outset.

Theory of Knowledge (TOK)

Why is it that despite having a lower average life expectancy and the existence of equal opportunities laws, no country allows men to retire earlier than women?

(iii) Immigration

In a globalized world, ever more people are migrating for work purposes. The United Nations defines a migrant worker as "*a person who is engaged in a remunerated activity in a State of which he or she is not a national*", i.e. anyone working outside their home country. For example, millions of Filipino and Indonesian women work overseas as domestic helpers in countries such as Singapore, Malaysia, Saudi Arabia and the United Arab Emirates. **Net migration** measures the difference between the number of people entering a country (immigration) and the number of people leaving (emigration).

Migrant workers contribute to the economic growth of the host country through their production, consumption and the payment of taxes. Many migrant workers also remit a significant proportion of their pay back to their home country, thus benefiting the country of origin. There are numerous reasons for the migration of workers, such as:

- *Pay and remuneration* - Many multinational companies attract migrant expatriate workers, especially those in senior posts, by offering them better pay and remuneration (such as relocation allowance, subsidised housing, medical cover and education allowance for those with children). Migrant workers might also choose certain countries for their low tax rates (see Table 7.1).

- *Employment opportunities* - Unemployment and poverty may prompt many workers in low-income countries to seek employment elsewhere. At the same time, high-income countries that experience economic growth have an increased need for labour, especially low-skilled workers.

- *Seasonal factors* - Agricultural workers, for example, might migrate during off-peak seasons to find employment in other countries.

- *Domestic instability* - Political instability, the lack of security and limited business opportunities in the domestic economy are key drivers for migrant workers.

- *Higher standard of living* - Migrant workers seek a better lifestyle so immigration can provide such possibilities. Working overseas may provide better career prospects for migrant workers and more educational opportunities for their children.

Table 7.1 - Tax rates (max % rate, for selected countries)

Country	Corporate tax	Income tax	Sales tax
Australia	30	45	10
Canada	15	33	5
India	40	30	18
Mexico	30	30	16
New Zealand	28	39	15
Poland	19	32	23
Romania	16	10	19
Spain	25	24.5	21
Turkey	22	35	18
Vietnam	20	35	10

Source: adapted from http://www.worldwide-tax.com/

Despite attempts to achieve effective human resource planning, external influences affect the accuracy of the forecasts. This is because businesses are constantly exposed to the forces of change (see Chapter 46), such as an economic recession which reduces the demand for human resources.

CORE

(iv) Flexitime

The traditional working hours for many industries was typically from 9am until 5pm on Mondays to Fridays. This rigid system no longer applies in the vast majority of businesses and countries. One alternative is to use **flexitime** (short for flexible time), a system which requires employees to work for a core period (say from 9am to 1pm) but the rest of the time is flexible. This means that employees have autonomy to determine when they will work, subject to them getting their work completed by set deadlines. For example, a worker who is required to work a 36-hour week might be able to work 9-hour shifts from Monday to Thursday and have Friday off.

Flexitime is increasingly popular in the UK and USA, especially following the COVID-19 pandemic that spurred the growth in the number of people working from home (see Tables 7.1 and 7.2). Legislation in the UK, introduced in 2003, made flexitime more accessible to parents of young children. The law was extended in 2007 to give carers of adults the right to request flexitime from their employers. Offering flexitime can improve a firm's image as it is seen to be providing equal opportunities to staff who are unable to work standard hours due to their other important personal commitments. They also help to reduce the need for paying staff to work overtime. Flexitime can also be beneficial to employees as it gives them a greater degree of freedom to balance their work-life responsibilities.

Two common forms of flexitime are teleworking and homeworking. **Teleworking**, coined by management consultant Jack Nilles in 1973, refers to working away from the office by using electronic forms of communication, such as telephones, the Internet and email. It is popular in the USA, Canada, Sweden, Finland and the UK. The trend has been partly due to increasing problems commuting in central business districts but mainly due to the technological advances. Examples of businesses that commonly use teleworking include insurance firms, banks, market research firms and airlines. These businesses have 'call centres' where a dedicated team of workers deal with customer enquiries and complaints on using telecommunications technologies. This frees up management time at individual branches as they do not have to deal with so many enquiries from customers. Teleworkers can be mobile, such as salespeople who spend a significant amount of their time commuting and visiting clients.

Homeworking is an aspect of flexitime whereby people work from their own homes. According to the International Telework Association and Council (ITAC), the number of people working from home in the European Union pre-COVID-19 (during business hours) was approximately 15% but rose to almost 40% by 2020. With advances in technology (such as wireless and mobile technologies) which allow employees to operate in almost any location, the number of homeworkers and teleworkers will continue to rise post-pandemic. The advantages and disadvantages of teleworking and homeworking for employees and employers are outlined in Tables 7.1 and 7.2.

Table 7.1 - The advantages and disadvantages of teleworking and homeworking for employees

Advantages	Disadvantages
• Job opportunities, especially for those living in remote areas. • Suitable for those who have to care for family members, such as parents of young children or carers of elderly parents. • Flexible working hours. • Benefits of not having to commute, such as travel costs, time and stress. • Autonomy in decision-making and choice of how to best organize work. • Possible income tax allowances for using personal property for employment purposes. • Lower costs of technology mean that more people can afford to work from home.	• There is a huge reliance on the use and reliability of ICT software and hardware. • Workers, partly due to the nature of flexitime, often exceed their contracted working hours. • Workers might suffer from social isolation (including boredom). • There is often less job security and less trade union representation for workers. • Employees are likely to face distractions working at home, especially those with young children and pets. • Teleworkers and homeworkers tend to suffer from a lack of authentic training and career development opportunities

Table 7.2 - The advantages and disadvantages of teleworking and homeworking for employers

Advantages	Disadvantages
• Reduced overheads due to savings on prime locations and office space. • Flexible and extended working hours can be offered to customers. • Flexible working practices enable firms to adjust for peak and off-peak trade. • Continuity of services from those hiring workers with young children or other dependents. • Flexitime workers have lower absenteeism rates than office workers. • Provides flexibility to deal with working time directives (laws) that govern the maximum hours of work per time period.	• Set up costs, such as the cost of ICT equipment, can be very high. • Flexitime requires tight control in recruitment processes as not everyone has the desired traits, such as initiative, experience and self-motivation. • Management, monitoring and control are more difficult as workers are off-site. • Technological breakdowns can cause major disruptions to flexitime workers. • Flexitime is not always possible, such as insufficient working space at home or the lack of security and confidentiality of data being held at home.



Figure 7.2 - An increasing number of people are choosing to work from home

Flexible work patterns, practices and preferences, such as teleworking, homeworking and portfolio working (see the 'gig economy' below), have meant that the average number of hours worked has increased. This has happened despite employment laws in some countries, such as within the European Union where there is a maximum working week of 48 hours.

Charles Handy's theory of the *shamrock organization* (see Chapter 8) suggests that businesses will gradually use fewer core staff to improve their flexibility. For example, firms are increasingly outsourcing projects and using consultants as part of their human resource planning. Reducing the number of core staff and employing more part-time workers also helps businesses to reduce their labour costs.

Likewise, workers will have to be more flexible and adaptable. There is no longer such a 'job for life' and people have to be prepared to move between occupations and perhaps industries to maintain employment. However, a multi-skilled and flexible worker will be highly attractive to potential employers.

Key concept

Discuss the **ethical** issues regarding the growing trend or flexitime which enables an increasing number of people to work from home.

CORE

Human resource management

Question 7.2 - McDonald's

McDonald's is the most globalized fast-food restaurant in the world, with over 38,000 outlets in 120 countries. Part of its successful **growth strategy** has been the ability to adopt flexible work practices. A significant number of the workers at McDonald's are students hired on a part-time employment contract. In Australia, the company uses the catchphrase "*Your money, Your hours, Your way*" as part of its recruitment plan. McDonald's actively encourages students to apply for jobs at their restaurants by using slogans such as "*Freedom to earn and learn*" and "*Freedom to fit work around your life*" on its website (https://mcdonalds.com.au/). In countries that encourage flexible work practices, McDonald's has been able to open some of its stores on a 24-hour basis.

(a) (i) Define the term *growth strategy.* *[2 marks]*

(ii) Outline what is meant by *part-time* employees. *[2 marks]*

(b) Examine the costs and benefits of flexible work structures to McDonald's and its employees. *[6 marks]*

(c) Discuss the likely consequences of flexible work practices on the human resource planning, recruitment and training at *McDonald's.* *[10 marks]*

(v) Gig economy

The **gig economy** refers to labour markets where workers are typically on short-term, flexible and temporary contracts. It also includes people who carry out freelance work as independent contractors. Workers in the gig economy do not have permanent employment contracts. Instead, they are often on-call or on-demand whenever needed to provide services to the firm's clients. The term comes from the performing arts where artists such as musicians and comedians are paid for individual appearances at events known as "gigs."

The gig economy typically involves gig workers and independent contractors connecting with clients or customers through an online platform. For example, customers might use DoorDash's online app to book food delivery to their place of work or residence. Other examples of gig economy services are shown in Box 7.1. There has always been a market for freelance and independent work, but the nature of disruptive technologies has rapidly expanded the size and scope of the gig economy.

William Bridges wrote about similar trends in his book, Job Shift (1994). He used the term *dejobbing* to explain the increasing number of people becoming independent workers rather than the conventional meaning of being an employee.



Figure 7.3 - Gig workers are independent contractors

Box 7.1 - Examples of gig economy services

- Accounting and finance services
- Childcare (babysitting) services
- Computer repair services
- Fitness training or coaching
- Food delivery services such as DoorDash and Deliveroo
- Grocery pick-up and delivery services such as Instacart and FreshDirect
- Housecleaning and home repairs
- Independent freelance management consultants
- Landscaping or gardening
- Music or dance performances
- Photography or videography services
- Proofreading, copywriting and editorial services
- Reselling items online via platforms such as Etsy
- Ride-sharing services, such as Uber and Lyft
- Tutoring or teaching services
- Website design, content development and editing services.

A *Reuters* report in 2017 found that 34% of the workforce (or around 60 million people) in America consisted of gig workers and that this number is expected to rise steadily. A Mastercard report published in 2019 predicted the gig economy in the US would be worth at least $455 billion in 2023. The outbreak of the COVID-19 coronavirus caused a huge number of people to work from home, largely due to national lockdowns, which fuelled a sudden rise in the number of people working in the gig economy.

Advantages of the gig economy include:

- Allows greater flexibility for workers, businesses and consumers as each gig is adaptable to their needs at that moment in time. It is particularly beneficial for flexible lifestyles.
- Workers also have the flexibility of working for a variety of employers to suit their needs, rather than working full-time with a single employer.
- Costs are lower for businesses as they do not have to hire as many full-time staff or pay employment-related benefits to so many people.
- It enables contractors and freelance workers to make extra income, often quickly and with minimal costs.
- In theory, gig workers are in (more) control of their work-life balance.

The limitations of the gig economy include:

- As there are no employees or employers in the traditional sense, workers miss out on important aspects including job security and fringe benefits, such as health insurance and sick pay (see Chapter 10).
- Although some countries impose a guaranteed minimum wage for gig workers in certain industries, gig workers do not typically receive a regular income.
- Gig workers do not have a clear professional career path nor do they have the social support of colleagues and managers in the same way as full-time employees do.
- Independent contractors are expected to record and file their own tax returns based on their gig income. By contrast, this bureaucratic task is done for employees by their employer.
- Gig workers often suffer from burnout due to working multiple contracts, often at odd hours. Despite the flexibility, the lack of parameters at work means gig workers are often overburdened, tired and stressed.
- Businesses take the risk of relying on an outsourced freelance contractor who may or may not deliver the required service to the client or customer's satisfaction. This can therefore harm the corporate image of the business.

The gig economy has also created many more opportunities for **portfolio workers**. This term was coined by Charles Handy (1990), to refer to people involved in a number of different jobs carried out simultaneously, often on a temporary basis. For example, the portfolio worker might be completing a project as a freelance editor for one business, whilst conducting market research for another and providing management consultancy services for yet another organization. The portfolio worker charges a fee for each unit of work carried out.

Portfolio working and the gig economy help to increase the flexibility and mobility of an organization's human resources. An advantage for the portfolio worker is that the variety of experiences can contribute to a more fulfilling career. The key drawback, as with gig workers, is the lack of job security. Ad hoc employment opportunities mean that portfolio workers and gig workers might not have any contracts at a particular point in time whilst being very busy at other times with several projects being undertaken concurrently. For instance, plumbers, electricians and landscape gardeners tend to have many projects going on at the same time in the summer but are less busy during the winter months.

Exam tip !

People who work in the gig economy are independent workers, so it is incorrect to use the phrase 'gig employee'. Instead, you should refer to those who work in the gig economy as 'gig workers' or 'independent contractors'.

Key concept

Is it **ethical** that workers in the gig economy are not generally protected by employment laws in the same way as those who work for an employer?

Key concept

What is the role of **creativity** in the gig economy?

Resistance to change in the workplace (AO2, AO3)

Reasons for resistance to change in the workplace. AO2
Human resource strategies for reducing the impact of change and resistance to change. AO3
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One of the major barriers to effective human resource management is the resistance to change in the workplace. According to Professor John Paul Kotter (1979) of Harvard Business School, there are four main reasons why people are resistant to change in the workplace:

- **Self-interest** often takes priority over organizational objectives. People may be more interested in (concerned with) the implications of change for themselves rather than the benefits that change might bring for the organization. Hence, they may feel that change simply involves too much extra effort.

- **Low tolerance** of change happens because people prefer familiarity rather than disruptions and uncertainties. A lack of security is sensed when people are put out of their norms or comfort zones. There could also be an element of fear from being made redundant, perhaps due to the introduction of new production techniques. Employees might also fear the challenges associated with adapting to change, such as not being able to work within an automated environment.

- **Misinformation** causes misunderstandings because the purpose of change has not been communicated effectively. Staff often feel that change is not necessary, especially if things are going well - as the saying goes "If it isn't broken, don't fix it". Misunderstandings and uncertainties can also arise due to the anxieties of the unknown caused by misinformation.

- **Different assessments of the situation** occur when there are different interpretations of circumstances, i.e. management and staff disagree on the purpose and merits of change. Managers may feel that restructuring of the workplace is necessary, for example, but workers might disagree as they are the experts in their roles and do not see the need for such change.

There is also the possibility of *ambivalence* (the internal conflict surrounding change where some people do not necessarily voice their concerns) which could underestimate the actual degree of resistance to change. When people are in a group situation, for example, they may conform to the majority view but would prefer to act differently themselves. Others might feel that if they are seen to actively resist change then they are overlooked in the future for any promotional opportunities within the organization.

Professor Kotter proposed the **six change approaches** model for reducing the impact of change and resistance to change (also see Figure 7.4):

1. **Education and communication** - This approach aims to inform and educate workers (and other stakeholders) about the change. Early communication and clarification can help stakeholders to see the rationale for change and establish a degree of trust. Perhaps more importantly, this reduces any unsubstantiated claims and rumours about the proposed change. Therefore, clear and timely communication is critical for reducing the impact of change and resistance to change.

2. **Participation and involvement** - This approach links with several motivation theorists such as Maslow and Herzberg (see Chapter 10) who argue that employee involvement in decision-making can motivate and improve morale amongst the workforce. Kotter argued that by involving employees in the change process, perhaps by a series of consultations, formal agreements and giving employees a sense of ownership of the change, they are more likely to accept change instead of resisting it. This helps to get staff agreement as workers have ownership over the decisions being made, including the approved methods to make the change happen effectively.

3. **Facilitation and support** - This approach is paternalistic in style (see Chapter 9) as managers become supportive of staff during difficult times of change, thereby averting potential resistance to change. Managerial support can come in numerous forms, such as planning and timing the change sensitively and effectively. For example, employees may need retraining to accommodate the new changes. If change involves redundancies, then support systems need to be implemented to help workers find alternative employment. Counselling employees to deal with their fears and apprehensions is another example.

4. **Negotiation and agreement** - This is the 'carrot' approach whereby managers use incentives to remove or limit resistance to change. This can be done by 'inviting' workers to accept amendments to their employment contracts to accommodate the new changes, for example. Alternatively, employees who resist change might be offered early retirement or redundancy incentives to leave the organization. At other times, managers may be willing to compromise to provide an incentive for staff to settle for the change.

5. **Manipulation and co-option** - This approach involves bringing a representative of those resisting change into the change process. The purpose, in theory, is to give them representation but in fact the underlying reason is to convert the representative's thinking so that the advantages of change can be communicated to those resisting change (whatever their reasons might be). These representatives, such as trade union leaders, are quite often given a symbolic role but the reality is that their view will not affect the desire of management to push for the change. This approach is, of course, seen as rather unethical and can backfire if those resisting change discover what the management team is really trying to do.

6. **Explicit and implicit coercion** - This is the 'stick' approach to dealing with resistance to change and is typically used as a last resort. Managers can use coercion (intimidation tactics) to force workers into accepting change, by threatening disciplinary action, dismissals, job losses, redeployment (transferring employees to other jobs) or not promoting employees. Due to employment legislation that exists to protect employees, coercion is likely to be carried out implicitly, if used by managers.



Figure 7.4 - Kotter's six change approaches to change management

Additional human resource strategies for reducing the impact of change and resistance to change covered in Chapter 13 (Unit 2.7 Industrial/employee relations for HL only students).

Key concept

Can methods such as manipulation and co-option or explicit and implicit coercion ever be regarded as **ethical** approaches to change management? Do context and perspectives matter?

Key concept

How do individuals, organizations and societies cope with **change** in the modern business world?

Business Management Toolkit

Discuss how force field analysis (see Chapter 55) can be used as a strategy for reducing the impact of change and resistance to change in business organizations.

Introduction to human resource management and the key concepts

Highly effective managers consider the impacts of change on human resource planning. For example, the forces of globalization and innovation that drive change in the business world require human resource managers to think about how information communication technologies (ICT) contribute to workforce planning. Managers in multinational companies face growing challenges in coping with workforces that may be geographically spread across many different countries, with huge cultural differences and working in contrasting and changing political and legal systems.

Change also requires managers to increasingly seek and develop a flexible workforce with employees who are able to adapt to changes in the external business environment (see Chapter 46). For example, businesses that employ a large proportion of part-time workers, such as fast-food restaurants and supermarkets, are able to take advantage of workforce flexibility based

on the needs of the organization. This is also a key reason for the sustained growth in the number of teleworkers and homeworkers in the services sector.

Managers are increasingly keen to know why people leave their organization through the use of *exit interviews*. These are interviews conducted with staff who have resigned in order to establish the true reasons about why employees have chosen to leave the organization. For example, employers might think that the remuneration package offered is competitive, although this might not be the view of the majority of the workers. Data and information from exit interviews can then be used by managers to improve staff retention and strategic human resource planning and enable them to adapt to organizational change more effectively.

Whilst there are costs associated with improving staff retention, most strategists believe that the long-term benefits are far greater. Theorists and entrepreneurs such as Charles Handy (see Chapter 11) and Sir Richard Branson argue that human resources should be viewed as an investment and that training and development are an essential part of any organization that has a sustainable future.

ATL Activity 7.1 (Research skills)

Investigate how innovations such as Twitter, Facebook and LinkedIn are changing the way that businesses recruit workers.

A good starting point is this article from *The Hindu Business Line*: http://goo.gl/1Fv1R2. You can also read about an innovative way to recruit casual, part-time and temporary workers, launched by the 23-year-old CEO of *OneShift* in Australia and New Zealand: http://goo.gl/pcfgop

Key concept

With reference to an organization of your choice, examine how **ethics** and **change** impact on its human resource planning.

REVIEW QUESTIONS

1. What is meant by human resource management?
2. What is human resource planning?
3. What are demographic changes and how do these influence human resource planning?
4. What is an ageing population and what are the consequences of this for workforce planning?
5. What is meant by labour mobility?
6. What is meant by net migration?
7. What is flexitime?
8. How does teleworking differ from homeworking?
9. What are the advantages and disadvantages of flexitime for employers?
10. What are the advantages and disadvantages of flexitime for employees?
11. What is the gig economy?
12. What are the advantages and disadvantages of the gig economy for employees?
13. What are the advantages and disadvantages of the gig economy for employers?
14. What are the main reasons for resistance to change in the workplace?
15. What are the main human resource strategies for reducing the impact of change and resistance to change?

KEY TERMS

An **ageing population** is a demographic change that tends to occur in high-income countries, with the average age of the population getting higher.



An ageing population has many implications for human resource management

Demography is the statistical study of population characteristics, using data such as birth rates, death rates, ageing populations and net migration rates.

Flexitime is a system that enables workers to have a degree of autonomy to determine when they work, so long as they complete their work by set deadlines.

The **gig economy** refers to labour markets where workers are typically on short-term, temporary contracts or carry out freelance work as independent contractors.

Homeworking is an aspect of flexitime whereby people work from their own homes.

Human resource management (HRM) refers to the role of managers in planning and developing the organization's people. This is done through interrelated functions such as the recruitment and selection, as well as training and development of employees.

Human resource planning (or **workforce planning**) is the management process of forecasting an organization's current and future staffing needs.

Migrant workers are people who move to other countries in search of better job prospects and opportunities.

The **mobility of labour** is the extent to which workers are flexible enough to move to different locations (*geographical mobility*) and/or their flexibility in changing to different jobs (*occupational mobility*).

Net migration measures the difference between the number of workers entering a country (immigration) and the number of people leaving (emigration).

Portfolio workers are those who simultaneously carry out a number of different jobs, often for various contractors, usually on a temporary basis.

Six change approaches is John P. Kotter's model for reducing the impact of change and resistance to change. It consists of six strategies or approaches: (i) education and communication, (ii) participation and involvement, (iii) facilitation and support, (iv) negotiation and agreement, (v) manipulation and co-option and (vi) explicit and implicit coercion.

Teleworking refers to working away from the office by using electronic forms of communication, such as telephones, the Internet and email.

Workforce refers to the number of employees at any one point in time for a particular organization.

Chapter 8

Unit 2.2 - Organizational structure

""Whatever affects one directly, affects all indirectly. I can never be what I ought to be until you are what you ought to be. This is the interrelated structure of reality"
- Martin Luther King, Jr. (1929 - 1968), Civil rights activist and Nobel Peace Prize (1964)

Contents

2.2 Organizational structure	
SL/HL content	**Depth of teaching**
The following terminology in relation to different types of organizational structures: • Delegation • Span of control • Levels of hierarchy • Chain of command • Bureaucracy • Centralization • Decentralization • De-layering • Matrix structure	AO2
The following types of organization charts: • Flat/horizontal • Tall/vertical • By product, by function, or by region	AO2, AO4
Appropriateness of different organizational structures given a change in external factors	AO3
Changes in organizational structures (such as project-based organization, Charles Handy's 'Shamrock Organization') (HL only)	AO3

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Organizational structure (AO2)

The following terminology in relation to different types of organizational structures: (i) Delegation, (ii) Span of control, (iii) Levels of hierarchy, (iv) Chain of command, (v) Bureaucracy, (vi) Centralization, (vii) Decentralization, (viii) Delayering and (ix) Matrix structure.

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Organizational structure refers to the formal interrelationships and hierarchical arrangements of human resources within a business. Businesses organize their human resources in various ways. In a small firm, such as a sole proprietorship, there may be an informal organizational structure as the business owner carries out a range of functions including marketing, operations management and finance. Their roles change depending on the

demands of the job at a particular point in time. The sole trader also carries out more mundane tasks such as being a salesperson and a stock controller. However, in most businesses there is a need for a more formal and organized structure as people have different job roles and responsibilities (see Box 8.1). This helps businesses to function more efficiently, due to accountability and responsibility.

- **Accountability** shows who is held responsible (or answerable) for each particular job or task, such as the marketing team being held accountable to the marketing director for their performance. Accountability allows senior managers to have better control over the running of their organizations.

- **Responsibility** shows who is in charge of whom and in what role or capacity, such as the operations management director being in charge of all production workers. Roles and responsibilities can be seen in an organization chart (see Figure 8.1).

Figure 8.1 shows a typical structure for a secondary (high) school. The Headteacher (Principal) is at the top of the organizational structure and is ultimately responsible for all the staff in the school. Managers are responsible for their own teams, such as the Head of Modern Foreign Languages who is in charge of the language teachers. S/he is accountable to the Deputy Head (Vice Principal) in charge of the school curriculum. Likewise, the Coordinator of PSE (personal and social health education) is accountable to the Heads of Year and responsible for working with the form tutors.

As an organization gets larger and more complex, it has to become more structured for tasks and roles to be fulfilled in a manageable and coherent way. Although businesses differ in their formal organizational structures, the typical configuration consists of different levels of directors (or executives), managers and workers (see Figure 8.2).



Figure 8.2 - Human resources in an organization

CORE

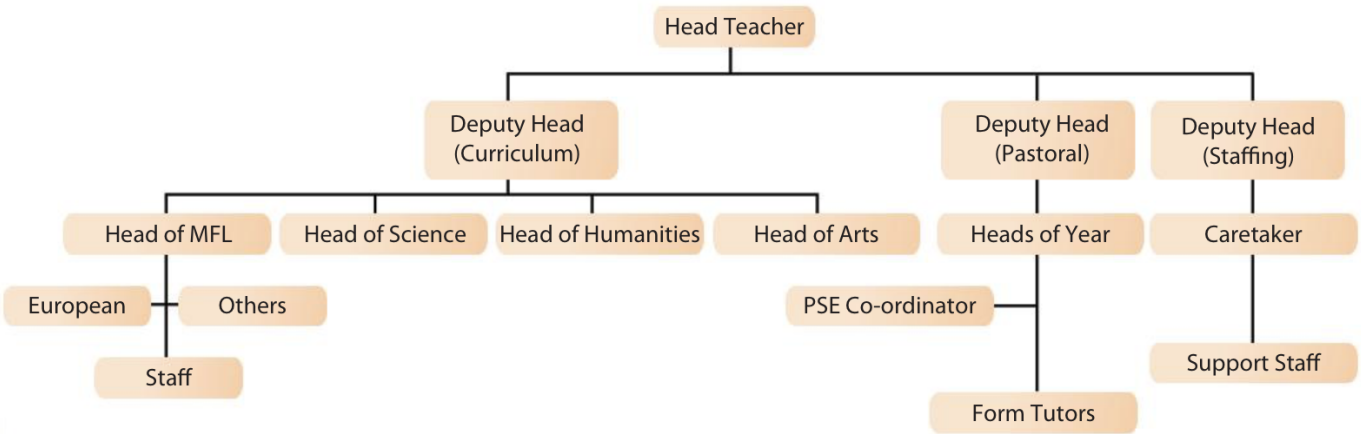

Figure 8.1 - Example of an organization chart for a secondary school

Box 8.1 - Job roles within an organization

- **Chief Executive Officer** (CEO) or **Managing Director** (MD) - The CEO represents the head of the Board of Directors (BOD) and is ultimately responsible for implementing corporate strategy and the success of the business. S/he is accountable to the company's BOD and shareholders.
- **Board of Directors** (BOD) - Directors, or executives, are responsible for the overall running of the business. In a large company, there is likely to be a director responsible for each key functional area (marketing, human resources, finance and accounts and operations management). Collectively, these executives are part of the senior leadership team that advise and support the CEO.
- **Middle management** - Managers are typically responsible for a team of people and/or certain tasks. They are decision makers with responsibility for the day-to-day operations of the business. They assist and are accountable to the BOD. Managers take on roles and responsibilities that are delegated to them by the directors.
- **Supervisors and team leaders** - Supervisors and team leaders carry out some, but not all, of the duties of middle management. They are involved in making operational decisions (daily or routine decisions). They are directly responsible for workers in their teams.
- **Other employees (Operatives)** - In a large organization, these people form the majority of the workforce. In a school, other employees include the majority of teachers (those not in a management position with additional areas of responsibility). Operatives include the office staff (such as secretarial and administration staff), technicians, caterers for the canteen, caretaker, cleaners and janitors and security staff.

Theory of Knowledge (TOK)

Why are there more male Chief Executive Officers in the corporate world than female CEOs?

To gain a better understanding of different types of organizational structures, the following terminology is stipulated in the syllabus: (i) Delegation, (ii) Span of control, (iii) Levels of hierarchy, (iv) Chain of command, (v) Bureaucracy, (vi) Centralization, (vii) Decentralization, (viii) Delayering and (ix) Matrix structure.

(i) Delegation

As a business grows, managers need to relinquish some of their roles and responsibilities because they are not able to effectively control all aspects of the organization. This passing on of control and decision-making authority to others is called **delegation**. It involves the line manager entrusting and empowering staff to complete a task or project but holding them *accountable* for their actions. The *responsibility* still remains with the line manager although the actual work is done by the authorised person to whom the work has been delegated.

The art of effective delegation is one of the most important skills of managers. Given time and other constraints, managers cannot and should not deal with every single matter themselves. Effective delegation (see Box 8.2) provides major benefits for both managers and employees:

- The manager saves time by not having to tackle every single task, so can focus more on the strategic issues facing the organization.
- Delegation can motivate and develop employees who feel that they are trusted and that their contributions are important.

By contrast, poor delegation causes confusion and a feeling of inadequacy. This leads to demotivated and less productive staff, resulting in a failure to achieve the tasks set.

Box 8.2 - SMARTER delegation

- **S**pecific - Delegated tasks must be clearly defined so that subordinates can carry them out effectively.
- **M**easurable - Results must be quantifiable to measure the extent to which the delegated tasks have been achieved.
- **A**greed - Both managers and subordinates must agree to the delegated tasks, including deadlines, in order to avoid any potential misunderstandings or conflict. They should also agree on the amount of power and freedom that goes with the assigned work.
- **R**ealistic - Delegated tasks must be reasonably achievable, otherwise workers will not be dedicated to completing them.
- **T**ime-bound - A timeframe must be set so that the delegated tasks are completed in a timely manner.
- **E**thical - Tasks must be delegated fairly to prevent dissatisfaction and resentment. Delegating only dull and unchallenging tasks simply demoralises and demotivates staff.
- **R**ecorded - Tasks should be documented to provide guidance and to aid recognition of them being accomplished. This also allows staff to be acknowledged and credited for their accomplishments.

Common mistake

Students often claim that delegation motivates because of the associated financial rewards. However, delegation does not always involve monetary compensation, but is instead a form of empowerment so can act as a non-financial motivator (see Chapter 10).

(ii) The span of control

The **span of control** refers to the number of people who are directly accountable to a manager. Hence, the higher up a person is in a hierarchy, the wider their span of control tends to be. Although the CEO of a company is directly responsible to the Board of Directors, s/he is also indirectly in charge of all workers in the organization, including all of the directors. Hence, the CEO's direct span of control is narrow, but the indirect span of control in very wide.

An advantage of a wide span of control (see Figure 8.3) is that fewer layers are needed in the organizational structure. In this example with 18 people, the CEO has two assistants who share a (wide) span of control of fifteen employees. This helps with cost control as there are fewer managerial positions in the firm. A flatter structure also means that communications between the different levels of the hierarchy should be more effective (in terms of speed and accuracy).

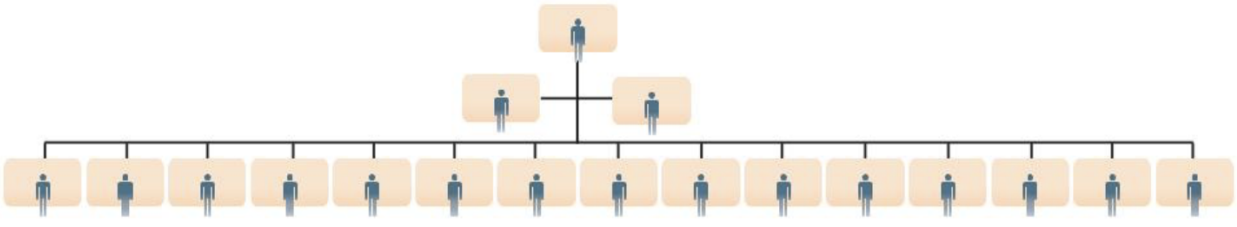

Figure 8.3 - Wide span of control

By contrast, a narrow span of control means that there are fewer subordinates who are accountable to a manager (see Figure 8.4). Here, the same number of people exists as in the previous example (eighteen), except that they have been arranged with narrower spans of control. It is therefore easier to communicate with and control the team. Smaller teams might also be more productive as there is likely to be better team spirit and cohesiveness. Larger teams tend to suffer from communication problems which may cause tension and conflict. However, due to more levels of management in the organizational structure, this configuration tends to be more costly.

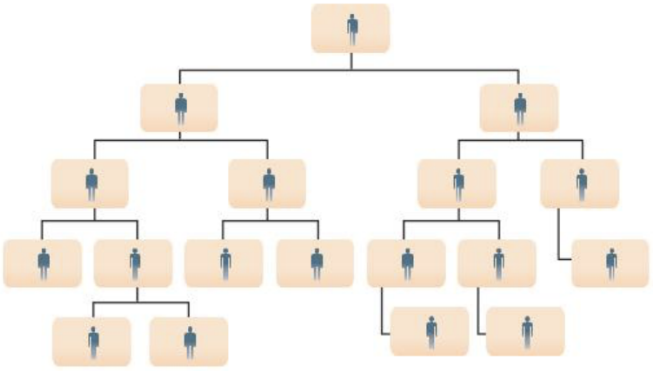

Figure 8.4 - Narrow span of control

So, what is the ideal span of control for a business? Management consultants have been debating this question for decades and stems from the works of Henri Fayol (1841 - 1922). It was V. A. Graicunas (1898 - 1947), a Lithuanian management consultant, who first used empirical evidence to address the question of the optimal span of control. Graicunas suggested that the maximum number of subordinates should be four (in most cases) or five to one manager. He argued that the span of control should be limited because "*One of the surest sources of delay and confusion is to allow any superior to be directly responsible for the control of too many subordinates.*"

However, there is no consensus on the optimal span of control. As the business environment continues to evolve, many businesses have opted for wider spans of control. In essence, the decision is judgmental. The degree of control granted to a manager depends on several factors, which can be remembered by the acronym MOST:

- **M**anager - The more skilled and experienced the manager, the more likely that s/he has a wider span of control. By contrast, junior managers have a narrower span of control.

- **O**rganizational culture - Narrower spans of control may be required in cultures that require managers to closely monitor and control their subordinates. By contrast, managers in democratic cultures tend to delegate and empower their subordinates, thereby allowing for a wider span of control. Such cultures prefer the term 'span of support'.

- **S**ubordinates - Highly skilled staff are more likely to work in smaller, dynamic teams with their line manager having a relatively wider span of control. Google uses an innovative approach, with a 60:1 span of control.

- **T**ask - Complex, urgent and important tasks tend to require a narrower span of control as communication will be more important, i.e. it is often more effective to have smaller teams where both accountability and responsibility can be clearly identified. By contrast, products that can be mass-produced (see Chapter 36) means that less supervision is needed. Hence, the span of control can be widened as workers have relatively simple tasks that can be done with minimal supervision.

Key concept

How do the concepts of **change** and **creativity** impact on the optimal span of control for an organization?

CORE

(iii) Levels of the hierarchy

The **hierarchy** in a business refers to the organizational structure based on a ranking system. Those at the top of the hierarchy include the CEO, Chairperson and the Board of Directors. At the other end, the least skilled employees appear at the bottom of the organizational hierarchy. Each hierarchical level refers to a different rank with its associated degree of authority and responsibility. Figure 8.5 shows an organization with 5 levels in its hierarchical structure.

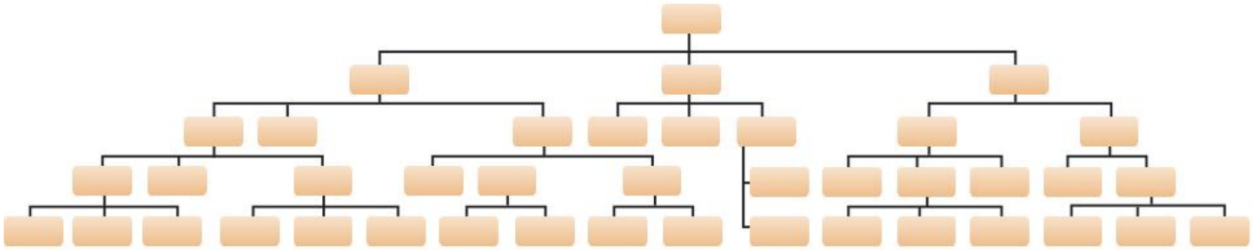

Figure 8.5 - Hierarchical structure

The person directly above an employee on the next hierarchical level is known as the **line manager.** For example, in Figure 8.5, those on level 5 (at the bottom) of the structure report directly to their line manager on level 4. A line manager is responsible for the day-to-day management of the people (known as *subordinates*) who are directly on the next level below in the hierarchy.

There are two main advantages of using hierarchical structures. First, they show clear lines of authority within the organization. This can improve the coordination and productivity of workers. Second, hierarchical structures establish departments or teams to create a sense of belonging in the workplace so can act as a form of motivation (see Chapter 10).

However, hierarchical structures also have their limitations. Departmentalisation can mean workers are isolated from their official teams (see Chapter 12 for the benefits of informal communications for an organization). Hierarchical structures also tend to be rather inflexible. This might prove problematic when there are changes in the external environment that may require flexible structural changes in the organization.

(iv) Chain of command

The chain of command refers to the formal line of authority through which communications and orders are passed down in an organization. This can be seen through a firm's organization chart. Businesses that have only a few levels of hierarchy have a short chain of command. By contrast, the chain of command is long in businesses that have many levels in its hierarchical structure.

For example, in Figure 8.1 (on page 110), if the Headteacher wanted to get a message to all teachers of Spanish and French, the formal chain of command would be communication via the Deputy Head (of Curriculum) to the Head of Modern Foreign Languages and to the Head of European Languages.

(v) Bureaucracy

Bureaucracy is the execution of tasks that are governed by official administrative and formal rules of an organization. Bureaucratic organizations are characterised by prescribed rules and policies, standardized procedures and formal hierarchical structures. Bureaucracy is often associated with excessive administration, paperwork and formalities. Within an organization, this might include:

- the frequent requirement to fill out excessive or cumbersome paperwork.
- staff working in multiple departments and therefore having to report to several managers.
- long, official chains of command.
- too many committees set up to investigate issues of concern to the organization.
- managers with duplicate or overlapping roles and responsibilities.



Figure 8.6 - Bureaucracy involves a lot of paperwork, policies and procedures

Karl Marx (1818 - 1883), a philosopher and political economist, argued that bureaucracy has a cost to organizations and society. However, as a socialist, he believed that the cost could be justified if bureaucracy is enforced properly. Max Weber (1864 - 1920), a German economist and socialist, built on the work of Marx, believing that bureaucracy was the ideal organizational structure. He argued that bureaucracy can be synonymous with efficiency because it is simply division of labour being applied to the administrative tasks within an organization. This is why many private sector firms have dedicated administrative departments. He suggested that a bureaucratic organization is governed by several principles, including:

- *Continuity* - The establishment follows official rules and regulations rather than taking high risks that might jeopardise its survival and continuity.
- *Rules and regulations* - Business activity is conducted in accordance with the official policies of the organization, such as clear lines of authority, responsibility and accountability.
- *Hierarchical structures* - Authority and responsibilities are part of a formal hierarchical structure with line managers carrying out their tasks in an impersonal and impartial way.
- *Accountability* - Business activity is conducted with written evidence of compliance with the firm's policies. Formality therefore makes all workers accountable for their performance.

However, the main drawback of bureaucracy can be summarised by Parkinson's Law (1955): "*Work expands so as to fill the time available for its completion*." In many organizations, bureaucracy hinders and/or prevents creativity and risk-taking and often slows down decision-making. Bureaucratic organizations tend to be highly inflexible since formal decision-making becomes slow and perhaps overly cautious.

Key concept

How do the concepts of **change** and **creativity** impact on the optimal span of control for an organization?

(vi) Centralization

Decision-making power can be either kept in the hands of a few people or it can be shared out among the workforce. The extent to which authority is concentrated or diluted within an organization depends on the traits and skills of managers and workers, the degree of trust and the corporate culture (see Chapter 11).

In a **centralized structure**, decision-making is made by a very small number of people. These decision makers, usually the senior leadership team of directors, simply hold onto decision-making authority and responsibility. Decisions are made through the person(s) in the centre (see Figure 8.7) without consultation with other members of the organization. This model was favoured by scientific management practitioners (see Chapter 10) such as Henri Fayol, Frederick Taylor and Henry Ford. The advantages and disadvantages of centralization are outlined in Table 8.1.

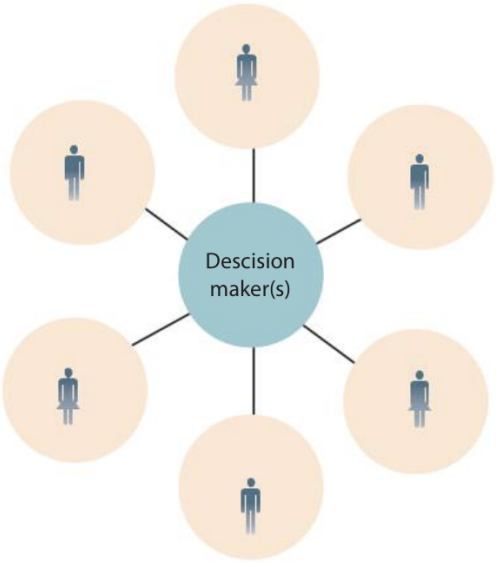

Figure 8.7 - The centralized structure

Table 8.1 - The advantages and disadvantages of centralization

Advantages	Disadvantages
Rapid decision-making - There is no need to consult employees about decisions. Therefore, quick decision-making can take place.	*Added pressure/stress for senior staff* - Decision makers do not delegate authority so face added pressures from extra workload.
Better control - Centralization allows managers to have a better overview and tighter control of what is happening in their organizations. This is particularly important in large firms where communications can break down due to a lack of overall control and authority.	*Inflexibility* - The organization becomes rather bureaucratic and inflexible as workers have very limited autonomy. They lack opportunities to be creative and simply follow the orders of decision makers. Hence, the skills and talents of employees are not recognised or acknowledged.
Better sense of direction - Decisions are made by senior leaders, i.e. the people who are most qualified to lead the organization. As there are fewer decision-makers, consistency in approach is also more likely to be achieved.	*Possible delays in decision-making* Since a centralized group makes all the decisions, it is likely that many decisions will eventually be delayed. This is simply due to the sheer number of decisions that the group needs to make, especially in large organizations.
Efficiency - Centralized control means that instructions are clear and tasks are less likely to be repeated by different people or departments in the organization.	*Demotivating* Employees lack opportunities to make a genuine contribution, so their motivation and productivity suffer as they feel less valued.

(vii) Decentralization

CORE

An alternative organizational structure is to use **decentralized structures**, whereby decision-making authority and responsibility are shared with others (see Figure 8.8). In this example, there are three levels of management that have decision-making authority and responsibility. Hence decision-making is more decentralized.

Another example is empowering departments or regional offices to make decisions on behalf of the overall organization. However, key strategic decisions are still concentrated in the hands of the CEO and the board of directors in the company's head office or headquarters. The advantages and disadvantages of decentralization are outlined in Table 8.2.

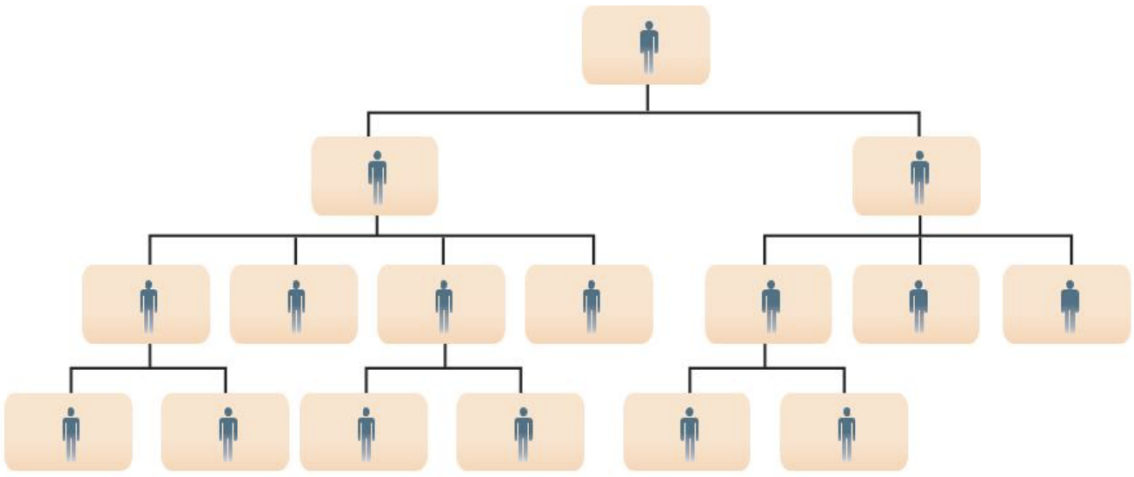

Figure 8.8 - The decentralized structure

Table 8.2 - The advantages and disadvantages of decentralization

Advantages	Disadvantages
Input from the workforce - Businesses can benefit from the skills, expertise and efforts of their employees, especially the input of their middle managers.	*Costly* - Empowerment and delegation often require financial incentives, such as better pay and remuneration for middle managers, as well as training opportunities
Speedier decision-making - Planning and execution are more efficient as there is delegation of authority and responsibility to others in the organization.	*Inefficiencies* - In decentralized organizations, middle managers might carry out duplicate functions as there is no overview of what everyone else is doing.
Improved morale - Empowered staff are more likely to feel valued and motivated as they have some input in the decision-making process. The autonomy also means that they can use their initiative and feel a sense of ownership for their work, so productivity also improves.	*Greater chances of mistakes* - Decentralizing authority and responsibility only works if the empowered workers are sufficiently competent and skilled. With more decision makers, it becomes more difficult to track where mistakes were made or where things went wrong
Improved accountability - Workers are held directly accountable for their input which can lead to improvements in the quality of their work	*Some loss of control* - By decentralizing decision-making, authority is diluted. Thus, senior leaders have less direct control over the operations of the business
Teamwork - A feature of decentralization is collaborative work across teams and departments. The sharing of ideas can foster harmonious relationships and generate creative and innovative ideas.	*Communication issues* - By decentralizing decision-making power, there is a greater need for efficient communication. This might require additional time and resources, which adds to the overall production costs

So, the question is whether businesses ought to become more centralized or decentralized. The decision will depend on several factors:

- *The size of the organization* - The larger the firm becomes, the greater the need for decentralization. For example, multinational conglomerates (see Chapter 6) cannot be efficiently operated using highly centralized organizational structures.
- *The scale of importance of the decision* - Decisions that have high-cost implications and/or consequences are more likely to be centralized.
- *The level of risk* - Similarly, high-risk decisions will remain in the hands of the key decision makers, i.e. remain centralized.
- *The corporate culture* - Organizations such as computer software companies that rely on the creative and innovative skills of employees tend to be decentralized. By contrast, factory operatives in low-skilled jobs producing mass produced goods are organized through centralization.
- *Management attitudes and competencies* - Managers who have a positive outlook towards worker attitudes and abilities are more likely to delegate power and authority. By contrast, managers who are unwilling to let go of their control or status are more likely to hold onto their centralized decision-making authority.
- *The use of Information Communication Technologies (ICT)* - Firms that adopt up-to-date methods of ICT are able to decentralize to a greater extent. For example, businesses that have a significant number of workers on flexitime (see Chapter 7) empower their staff to work from home who away from the office.

Question 8.1 - Ferrari



Ferrari, the Italian sports car manufacturer, was founded in 1947 by Enzo Ferrari. The company prides itself on the outstanding build quality of its prestigious cars. Workers are exceptionally skilled and have a high degree of decision-making power due to **decentralization.** According to Ferrari, 88.5% of its 2,695 workers in Maranello, Italy have attended training programmes to develop their managerial and professional skills.

(a) Define the term *decentralization.* *[2 marks]*

(b) Explain why skills training is important to firms such as Ferrari. *[4 marks]*

(c) Explain **two** factors that influence the degree of decentralization at organizations such as Ferrari. *[4 marks]*

CORE

Human resource management

(viii) Delayering

Many large businesses have opted to delayer their organizations. **Delayering** is the process of removing one or more levels in the hierarchy to flatten the organizational structure. This reduces the number of layers and widens the span of control in the hierarchy. Table 8.3 outlines the advantages and disadvantages of delayering.

Case study 8.1 - Haier

Haier is the world's largest producer of domestic appliances, including air conditioners, cookers, freezers, fridges, microwave ovens, mobile phones, televisions and washing machines. In late 2013, the company's CEO, Zhang Ruimin, delayered the organization by removing the company's entire middle management layer from its formal structure. The move was driven by Zhang's desire to encourage innovation and teamwork.

Table 8.3 - The advantages and disadvantages of delayering

Advantages	Disadvantages
Reduces costs - Cost savings are made on the salaries and benefits previously paid to middle managers that have been removed due to the flattening of the hierarchical structure.	*Creates anxiety* - Workers may develop a sense of insecurity as they become worried about their jobs, e.g. some are made redundant and others are demoted. These issues harm morale and productivity.
Improves communication - Communications flow more effectively due to the flatter hierarchical structures. This is also due to shorter chains of command.	*Increased workloads* - This adds extra burdens and stress on workers, which can be counter-productive and reduce the quality of work.
Encourages delegation and empowerment - There are wider spans of control, which should provide more opportunities for workers to take on wider responsibilities.	*Slower decision-making* - Managers deal with larger teams, so decision-making can take longer. It can also create problems for meeting deadlines

Question 8.2 - Restructuring at Southmead College

Over 50 teachers at Southmead College went on strike over staff restructuring plans set out by Trish Dagg, the principal. She argued that restructuring was necessary to cut costs and to generate funds to invest in equipment and **training** for the College's 150 staff members. The restructured organization would generate minimal redundancies and some middle managers would be demoted to classroom teachers to cut costs. Staff at Southmead College were angry as the restructuring meant that some teachers would get a pay cut of up to $11,200 a year.

(a) Define the term *training*. *[2 marks]*

(b) Discuss the decision to restructure Southmead College. *[10 marks]*

Common mistake

Many students confuse the term *delayering* with *downsizing*. Whilst downsizing involves a reduction in the workforce, perhaps due to mass redundancies, delayering simply means removing at least one level in the hierarchical structure, without anyone necessarily losing their job.

(ix) Matrix structure

A **matrix structure** is the flexible method of organizing employees from different departments to temporarily work together on a particular project. Functional departments still exist, although the project team has the opportunity to work with colleagues from other departments. Each member in the matrix organization is held accountable to two managers - their official department (or line) manager and their project manager.

Teams work better if the team members are highly skilled and experienced, so the project manager does not need to micro-manage individuals. Hence, it is the aptitudes and attitudes of team members in matrix structures that are important, rather than their formal rank in the official organizational structure.

Suppose, for example, that a project team was set up to investigate the best way to launch the opening of a new store. The members of the team might consist of one representative from each of the following departments: marketing, finance, human resources, information technology (IT) and operations management, as well as a member of the Board of Directors. Figure 8.9 shows that communications in a matrix organization do not happen in a traditional hierarchical way using formal chains of command. The advantages and disadvantages of matrix structures are outlined in Table 8.4.

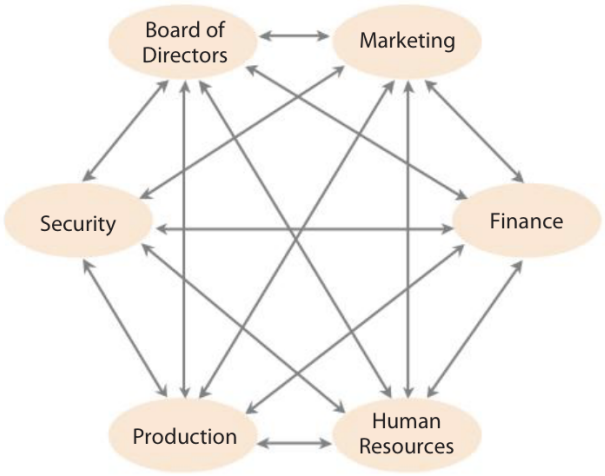

Figure 8.9 - The matrix structure

Key concept

How do the concepts of **change** and **creativity** impact on the optimal span of control for an organization?

Table 8.4 - The advantages and disadvantages of matrix structures

Advantages of tall (vertical) structures	Advantages of flat (horizontal) structures
Improved communications - Matrix structures can help to break down traditional barriers between different departments, thereby improving communication across the entire organization.	*Added workloads* - Members of matrix structures work across teams for certain projects as well as within their own department or functional area, which can be a burden.
Maximizes skills set of the workforce - Matrix structures allow individuals to use their set of skills across a variety of contexts in the workplace.	*Difficult to coordinate* - Members of project teams need to report to two line managers, so there can be conflicting or divided loyalties, making coordination challenging.
Cost-effective - This structure can be a good way of sharing ideas and resources across departments within the organization.	*Time consuming* - It takes time for teams in a matrix structure to achieve as the project is not their main area of work.

CORE

Organization charts (AO2, AO4)

The following types of organization charts: (i) flat/horizontal, (ii) tall/vertical, hierarchical and (iii) by product, by function or by region. AO2, AO4
Appropriateness of different organizational structures given a change in external factors. AO3
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Human resource management

An **organization chart** is a diagrammatic representation of a firm's formal organizational structure. Formal groups are established to carry out specific functions or job roles, such as a team of finance specialists or a department of marketers (see Figure 8.10). Most formal groups are permanent although businesses can set up temporary groups to investigate a particular issue or problem (see matrix structures above). An organization chart shows five important features of a business:

- The different *functional departments* within a business - In Figure 8.10 there are four functional departments shown: Marketing, Production, Finance and Human Resources. Each of these is headed by a Director. It shows how different areas of the business link to one another and verifies staff positions in the overall organization.
- The *chain of command* - This shows the various positions of authority in the organization. In particular, it shows

which people have direct line authority over others, such as the Production Director having line authority over all employees in the Production Department, namely the Operations Manager, the Security Director, the Quality Controller, Production operatives and the Security staff.

- *The span of control* - This measures the number of staff directly accountable to a single line manager. For example, the CEO has a direct span of control of four people (the four Directors). Each Director has a direct span of control of one (their deputy manager) except the Production Director who has a span of control of two (the Security Director and the Operations Manager). It shows which people have authority and the extent of the responsibility they have for others within the business.
- The official *channels of communication* - This is the route that messages are communicated within the organization. For example, communications that concern only the Finance team would go through the CEO, Finance Director, Finance Manager and the Finance staff.
- The *levels of hierarchy* - Figure 8.10 also shows there are five hierarchical levels. The CEO is at the top level whereas production operatives are on the bottom (fifth) level. It shows different workers which line manager they must report to, so that there is formal accountability.

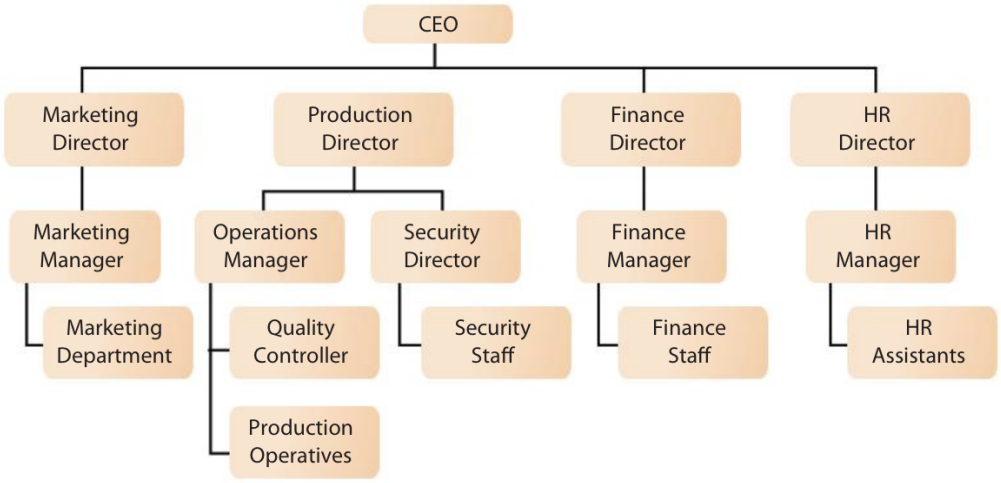


Figure 8.10 - Example of an organization chart

Question 8.3 - Organization charts (1)

(a) Construct two separate organization charts based on the following information:

(i) A partnership with two owners, each with a 50% stake in the business, who have direct control over their 5 employees. *[2 marks]*

(ii) A privately held company with 3 people on the board of directors, three department managers, each with a team of three people. *[4 marks]*

(b) Contrast the two organization charts from above by referring to the span of control and the chain of command. *[4 marks]*

(c) Explain **two** consequences to a business that chooses to adopt a wider span of control. *[4 marks]*

The following types of organization charts are specified in the syllabus: (i) flat/horizontal, (ii) tall/vertical and (iii) by product, by function or by region. You are also expected to be able to understand the appropriateness of these different organizational structures given a change in external factors.

(i) Flat (horizontal) organization charts

A flat (or horizontal) organizational structure has only a few levels in its organization chart, showing minimal levels between the operatives and the CEO. Therefore, each manager has a wider span of control, as shown in Figure 8.11.

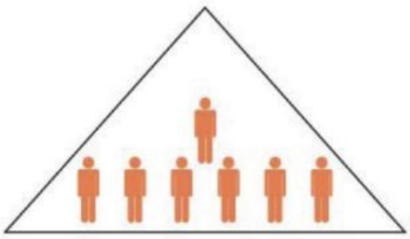


Figure 8.11 - Flat organization structure

The advantages of horizontal (flat) structures are outlined below. By default, the disadvantages of flat structures are the advantages of tall (or vertical) organizational structures which are explained in the section below.

- Delegation becomes a relatively important part of managing the organization. Hence, there are opportunities for subordinates to take on extra responsibilities and to develop their careers.
- Communication should be improved overall since there are fewer layers in the hierarchy.
- It is cheaper to operate because there are fewer managers to be hired due to fewer levels in the hierarchy. Many of these managerial functions are either eliminated or delegated.
- Flat structures can help to eliminate a 'them and us' culture so workers do not feel alienated from senior management, i.e. there is less of a psychological distance between senior managers and those at the bottom of the hierarchy.

Flat organizational structures are likely to exist in cultures that foster creativity and innovation, by empowering workers to make important decisions and to act on their own initiative.

Case study 8.2 - Bank of Italy

In 2014, the Bank of Italy flattened its organizational structure, with decision-making power decentralized to the central bank's eight directors. The restructuring was part of the bank's five-year plan to cut the number of employees by 10%.

(ii) Tall (vertical) organization charts

A tall (or vertical) organizational structure has many levels in the organization chart. Therefore, managers tend to have a narrower span of control, as shown in Figure 8.12. This is a traditional approach to organizing human resources in a business where emphasis is placed on subordinates reporting to their line manager.

The position of workers in the hierarchy indicates their rank (seniority), status and level of authority. Those at the top of the hierarchy (the CEO and Directors) are the most vital to the organization and are remunerated with a larger salary and benefits as they carry the most responsibility.

Organizational structures that are very tall tend to be bureaucratic as there are many levels in the rigid hierarchy, with work processes formally regulated by rules, policies and procedures. Such structures promote specialization at each level in the organization as workers have a relatively narrow focus.

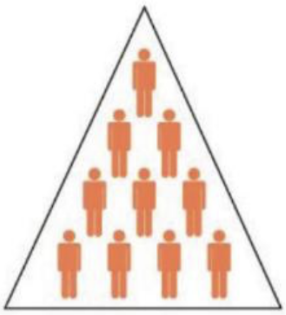


Figure 8.12 - Tall organization structure

The advantages of tall (vertical) structures are outlined below. By default, the disadvantages of these structures are the advantages of flat (or horizontal) organizational structures which were explained in the section above.

- There tends to be quicker and more effective communication within smaller teams. By contrast, a wide span of control means the manager has to communicate with many more people and deal with many more issues.

- Smaller teams are generally easier to control and manage, with greater team cohesiveness.

- Greater specialization and division of labour can help to increase efficiency and productivity. Hence, managers do not have to spend as much time monitoring their teams.

- There are greater opportunities for more people to be promoted as more levels exist in the organizational hierarchy. This can motivate some employees to work harder, thus improving staff retention and labour productivity.

(iii) Organizational by product, function or region

An alternative to structuring an organization in a tall (vertical) or flat (horizontal) way is to arrange human resources by product, function or region.

- **Organization by product** - Most large businesses have a broad range of products. Hence, they might choose to structure their human resources according to the various types of products produced or sold. Each department focuses on a different product within the organization's overall product portfolio. For example, some American restaurant giants uses this organizational structure for its various subsidiaries such as KFC, Pizza Hut and Taco Bell.

- **Organization by function** - Most businesses are organized by function, i.e. the different operational roles within a business such as Marketing, Production, Finance and Human Resources. Some businesses will also have functional departments in charge of Administration, ICT and Research and Development (R&D).

- **Organization by region** - Multinational companies (see Chapter 6) are often organized by geographical region. This allows the business to be more aware of and responsive to local and cultural differences. Such organizational structures allow regional managers to have better overall control over staffing and training issues as well as the varying needs of their customers.

The organization chart in Figure 8.13 shows organization by product, function and region.

- *Function*: There are three Vice Presidents of the business, each in charge of one functional area (Marketing, Production and Finance).

- *Region*: Plant managers are located in Thailand, Singapore and Vietnam. They are accountable to the Vice President in charge of Production. The same structure exists in these locations for the Marketing and Finance Departments.

- *Product*: Within each region, there is organization based on either consumer products or industrial products.

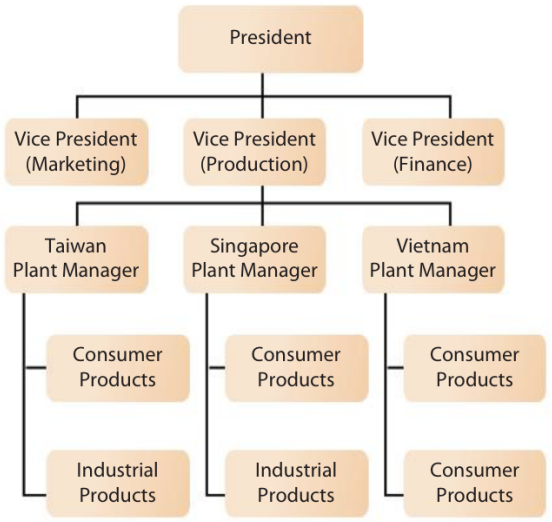


Figure 8.13 - Multi-forms of organizational structure

Question 8.4 - Organization charts (2)

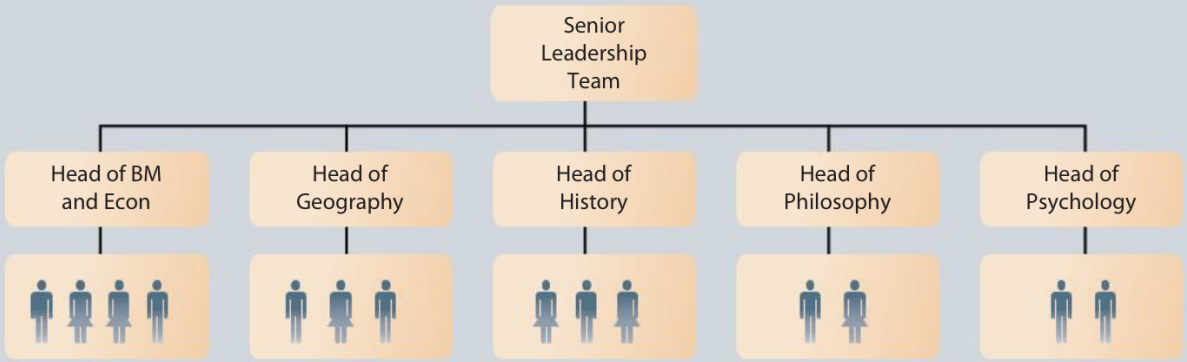
(a) With reference to Figure 8.12, identify who the Plant Managers are accountable to and who they are responsible for. *[2 marks]*

(b) Using Figure 8.12, describe what is meant by *span of control* and *levels of hierarchy*. *[4 marks]*

(c) Explain how an organization chart might be used in a firm's induction programme. *[4 marks]*

Question 8.5 - Departments or faculties?

Many IB World Schools are organized by functional departments, who are held accountable to the Senior Leadership Team. For example, Group 3 subjects (such as Business Management, Economics, Geography, History, Philosophy and Psychology) can be organized as completely separate departments (see below). However, in other schools these subjects are grouped together as an Individuals and Societies (or Group 3) Faculty, whereby the individual subjects are coordinated by Head of Subjects who are accountable to the Head of Faculty.



(a) Explain how the above organization chart would be affected if the separate departments were to be line managed by a Head of Faculty in charge of Group 3 subjects. *[4 marks]*

(b) Discuss whether it is more effective for schools to be organized as departments or as faculties. *[10 marks]*

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Changes in organizational structures (HL only)

Changes in organizational structures, for example, (i) project-based organization and (ii) Charles Handy's "Shamrock Organization" (HL only). AO3

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Organizational structures do not have to be fixed in the way described above, with tall or flat structures or organization by product, function or region. Flexible structures, used to adapt to changes in the internal and external business environments include project-based organization and Charles Handy's model of the Shamrock Organization.

(i) Project-based organization

In a project-based organization, human resources are organized around particular projects or development plans. Many businesses use a project-based organization chart, such as those in construction, software engineering, entertainment, aerospace and oil exploration. Project-based structures allow such businesses increased flexibility to adjust quickly to market changes and to adopt rapid innovations. Each project is led by a project manager supported by a team of workers (see Figure 8.14). For example, a construction company might have several teams working on different projects such as the building of a bridge, motorway or hospital.

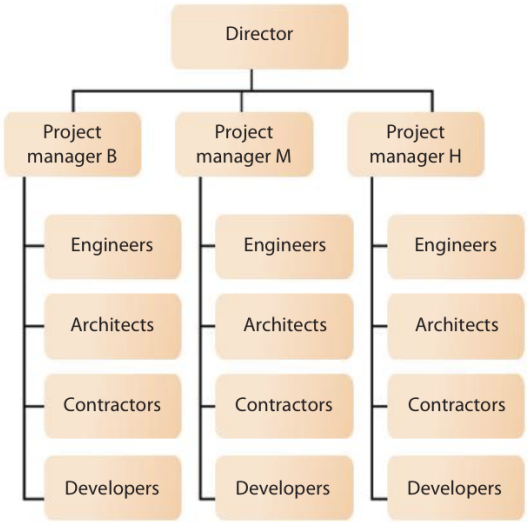

Figure 8.14 - Project-based organization chart

Table 8.5 - The advantages and disadvantages of project-based organization

Advantages of project-based organization	Disadvantages of project-based organization
Flexibility - As projects are time-limited by definition, project-based organizational structures continuously change as projects are completed, to the needs of clients and new projects are initiated.	*Discontinuity* - As workers always move between projects, with different teams and project managers, there could be fewer opportunities for people to develop personally and professionally.
Productivity - Projects are focused on solutions rather than functionality. Project managers focus on implementation, striving to meet deadlines and operating within the assigned budget of the project.	*Isolation* - Each project team is self-sufficient yet usually only operates temporarily. There are very limited opportunities to work with other teams or people in the rest of the organization, creating a sense of isolation.
Efficiency - As the project manager has direct control and authority over the project, tasks get done quicker. Efficiency is further improved if the project manager can assemble the team, made up of people most suited to the project.	*Inefficiencies* - Each project needs its own finances and team of experts, often resulting in a duplication of resources and effort. As people continuously move from one project to another, there can be added pressures and stress for staff.
Motivational - Project-based organization can be a source of motivation because individuals are able to work on different projects, so this adds interest and variety to their work. It also broadens their professional experiences and project portfolio.	*Conflicting interests and priorities* - Project teams are usually formed on a temporary basis, so it can be challenging to develop team spirit and cohesiveness, especially if the team members come from departments with different cultural norms.

HIGHER LEVEL

In many businesses, project-based organization is used for a temporary period to execute specific projects, with teams focusing on their assigned project rather than on their position in the firm itself. The workers are often from different functional departments, similar to a matrix structure, but come together to focus specifically on completing a particular project. Project managers can have several project groups reporting to them on projects, such as product development or expansion in an overseas market. The advantages and disadvantages of project-based organization are outlined in Table 8.5.

(ii) Charles Handy's "Shamrock Organization"

Charles Handy (born 1932), co-founder of the London Business School in 1967, believes that people are the most important resource in any organization. His ideas differed markedly from those of Henri Fayol (see Chapter 9) and F.W. Taylor (see Chapter 10) who both believed in tall hierarchical structures with close supervision of workers. By contrast, Handy recommends that businesses ought to place greater emphasis on meeting the needs of workers through methods such as *job enrichment* (giving workers more interesting and challenging tasks) and *flexible working practices*. For example, university students in part-time employment and parents with young children would have more choice over the hours that they work. Handy believes this helps to improve the well-being and morale of workers and hence boosts labour productivity.

Handy emphasized the dynamic nature of change within organizations as well as the external business environment, thus requiring changes in organizational structures. He did not believe in 'jobs for life' but that short term contracts were more appropriate. He argued that non-essential work (that is, jobs that can be done by other organizations) should be contracted out (outsourced) to specialists who can do the work more productively and cost efficiently. The trend in the large number of organizations that subcontract business activities supports Handy's research. For example, schools might subcontract their non-core services such as security, catering and buildings maintenance.

Due to these structural changes, Handy coined the concept of the **Shamrock Organization** in 1991. The model gets its name from the shamrock plant, a three-leafed clover (see Figure 8.15). Handy suggested that there are three groups of workers within a shamrock organization.



Figure 8.15 - The shamrock plant

- **Core workers** - Also known as the **professional core**, this group consists of full-time and multi-skilled professional workers (such as managers and professional technicians) who handle the daily operations of the business. They are crucial to the organization's operations, survival and growth. With developments in teleworking and flexitime (see Chapter 7), core workers are becoming smaller in size. This has led to downsizing and restructuring of the workforce in many businesses.

- **Peripheral workers** - Also known as the **contingent workforce**, this group consists of part-time, temporary and portfolio workers who are employed as and when they are needed on a flexible basis. They tend to be paid by piece rate for short periods of employment, thus helping to reduce overall labour costs for the firm. The peripheral group forms the flexible workforce for an organization (see Chapter 7) and constitutes a greater proportion of the workforce for large businesses. For example, supermarket chains such as Walmart, Tesco and Carrefour employ far more part-time staff than full-time workers.

- **Contract workers** - This group, also known as outsourced workers, consists of individuals or businesses that are not employed by the organization but are paid to complete particular and specialized tasks, such as advertising campaigns or skills training. Freelance workers, subcontractors, agencies, consultants and the self-employed are examples of outsourced workers; they are hired by an organization for their expertise. For instance, most large firms use marketing agencies to design appropriate promotional campaigns (see Chapter 29).

The three parts of the Shamrock Organization have their own advantages and limitations for a business. The core workers, vital to the organization, must be well paid and remunerated. They are likely to enjoy some degree of job security, be highly motivated and very productive. The peripheral workers will suffer from a lack of job security thereby negatively affecting their morale. However, they present flexibility for an organization and are easier to 'hire and fire'. The outsourced workers are experts in their fields but are therefore likely to be relatively expensive.

Although Handy introduced the idea of the Shamrock Organization back in the early 1990s, time has shown that businesses are indeed restructuring to become more flexible in their organizational structures, reducing the core staff and opting to use more peripheral and outsourced workers. The trend in the number of businesses globally that use increasingly more part-time workers and adopt flexible working practices supports Handy's foresight.

Organizational structure and the key concepts

Human resources are undoubtedly essential to any business organization, given their creativity potential and changes in the internal and external business environments. Effective organization of people requires careful strategic human resource planning (see Chapter 7). An organization chart is an important aspect of strategic planning as it allows people to see:

- The overall structure of human resources in the organization
- Each manger's scope of responsibility
- Those who must report to a certain line manager
- The formal chains of command.

An inefficient organizational structure can cause staff demotivation, a duplication of effort, communication problems, difficulties in coordination and poor decision-making. Hence, organization charts can be useful visual tools for the process of change and change management.

As an organization evolves and grows, it is inevitable that change will create new job roles as well as make other roles redundant. The increased need for human resources in creative and flexible ways means that managers may have to restructure the organization as part of their overall strategic plan. For example, tall structures, which were popularised in the 1930s, have given way to flatter structures in many large organizations today. Delayering not only cuts costs and unnecessary management roles (financial rewards for managers are typically based on their hierarchical rank), but also leads to more effective communications (see Chapter 12). Delegation of decision-making authority is also pushed down and spread out amongst those lower in the hierarchy. As a result, productivity should improve. For example, Japanese companies found that the strategic implementation of matrix structures and quality circles (see Chapter 37) creates synergy, thereby improving their overall efficiency and competitiveness and in a more sustainable way. However, overseas expansion also means that managers have to be aware of potential cultural differences (see Chapter 11) and approaches to organizational structures.

Although there has been extensive research into the optimal organizational structure, the conclusion is that there simply isn't a model that suits all organizations. Each model has its own strengths and weaknesses and every organization is unique in its character, code of ethics and culture. The 'best' or optimal strategy depends on several key factors, including:

- The size of the business - Larger organizations tend to require more formal structures.
- Employee competencies - Organizations with highly skilled workers can adopt relatively flat, flexible or project-based structures, whereas those with low-skilled workers require a more formal and rigorous structure.
- Management attitudes - Managers who are able to trust their staff and are willing to relinquish or delegate decision-making power are more likely to implement flatter and flexible work structures.
- The culture of the organization - Creative and innovative organizations that are accustomed to change, for example, might opt for more flexible, project-based structures.

In today's fast-paced business environment, where change is unavoidable, flexibility is a key feature of an organization's business strategy. Since many decisions and actions need to be spontaneous, the decision-making process can no longer be heavily centralized. For example, if firms choose to adopt Handy's Shamrock Organization, then the internal structure of the business needs to be reviewed. This often leads to delayering caused by downsizing (when the size of the core workforce in the Shamrock Organization is reduced). This strategy can lead to more flexible working practises (see Chapter 7) as firms hire more peripheral and temporary workers. These people are not

HIGHER LEVEL

always entitled to the same remuneration as core full-time staff, with benefits such as statutory sick pay, holiday pay, health insurance and contributory pensions (see Chapter 10).

Key concept

Discuss whether downsizing and mass redundancies can ever be considered to be an **ethical** business practice.

Key concept

With reference to a business of your choice, examine how **change** influences its organizational structure

Business Management Toolkit

Discuss how knowledge of Hofstede's cultural dimensions (see Chapter 54) can influence organizational structures.

REVIEW QUESTIONS

1. What is meant by organizational structure and what is its purpose?
2. How does accountability differ from responsibility?
3. What is meant by delegation?
4. What is meant by span of control?
5. What are the advantages of a wide span of control?
6. What are the advantages of a narrow span of control?
7. What is meant by levels of the hierarchy in an organization?
8. What is the chain of command?
9. What is bureaucracy?
10. What are the differences between centralized and decentralized structures?
11. What is delayering?
12. What is a matrix structure?
13. What is an organization chart?
14. What are the differences between flat and tall hierarchical structures?
15. What are the differences between organization by product, function and region?
16. What is project-based organization?
17. What is the Shamrock Organization and how does it differ from traditional organizational structures?
18. In the context of the Shamrock Organization, what is meant by core workers?
19. In the context of the Shamrock Organization, what is meant by peripheral workers?
20. In the context of the Shamrock Organization, what is meant by contract workers?

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KEY TERMS

Accountability describes the extent to which a person is held responsible for the success or failure of a task or job. It allows senior managers to have better control over the running of their organizations.

Bureaucracy is the official administrative and formal rules of an organization that govern business activity. It involves prescribed rules and policies, standardized procedures and formal hierarchical structures.

Centralization occurs when the majority of decision making is done by a very small number of people (usually the senior leadership team) who hold decision-making authority and responsibility.

Chain of command refers to the formal line of authority, shown in an organization chart, through which formal communications and orders are passed down.

Decentralization occurs when decision making authority and responsibility are shared with others in the organization.

Delayering is the process of removing levels in the hierarchy to flatten the organizational structure, thereby widening the span of control in the hierarchy.

Delegation is the empowerment of a person lower down in the organizational structure by passing on control and decision-making authority to complete a certain task or role.

A **flat** (or **horizontal) organizational structure** means that there are only a few layers in the formal hierarchy and hence managers have a relatively wide span of control.

The **hierarchy** in a business refers to the organizational structure based on a ranking system. Each hierarchical level refers to a different rank with its associated degree of authority and responsibility.

Levels of the hierarchy refer to the number of layers of formal authority in an organization. The number of levels is shown in an organization chart.

Line manager refers to the person directly above an employee in the organizational structure.

Managers are the people responsible for the day-to-day running of the business or a department within the organization.

A **matrix structure** refers to a flexible type of organizational structure of representatives from different departments, temporarily working together on a particular project or job.

Organization by function refers to structuring a workforce according to business functions, i.e. specialized roles or tasks such as marketing or finance and accounts.

Organization by product refers to structuring a workforce according to the goods or services produced or sold. Each department focuses on a different product within the organization's overall product portfolio.

Organization by region refers to structuring a workforce according to different geographical areas, based on where the firm's operations are.

Organization chart is a diagrammatic representation of a firm's formal structure of human resources.

Organizational structure refers to the formal interrelationships and hierarchical arrangements of human resources within a business.

Outsourced workers, in Charles Handy's Shamrock Organization, are the individuals or organizations hired on a contract basis to carry out specific but non-core roles.

Peripheral workers, according to Charles Handy, are the contingent workers consisting of part-time and temporary staff hired by the organization to provide greater flexibility.

Professional core, according to Charles Handy, are the core workers consisting of full-time specialists (professionals) who are vital for the organization's operations and survival

A **project-based organization** arranges human resources around particular projects, each led by a project manager. Such structures allow increased flexibility to adjust quickly to market changes and to adopt rapid innovations.

Responsibility refers to who is in charge of whom and in what role or capacity. Roles and responsibilities can be seen in an organization chart.

The **Shamrock Organization** refers to Charles Handy's model that organizations are increasingly made up of core staff who are supported by peripheral workers and outsourced workers (consisting of consultants and contractors).

Span of control refers to the number of subordinates overseen by a manager, i.e. the number of people who are directly accountable to the manager.

A **tall** (or **vertical) organization structure** means that there are many layers in the hierarchy and hence managers have a narrow span of control.



Figure 8.14 - The span of control refers to the number of people who directly report to a manager

Chapter 9
Unit 2.3 - Leadership and Management

"Some are born great, some achieve greatness and some have greatness thrust upon 'em.""
- William Shakespeare (1564 - 1616), British author

Contents

2.3 Leadership and management	
SL/HL content	**Depth of teaching**
Scientific and intuitive thinking/management (HL only)	AO2
Management and leadership	AO2
The following leadership styles: • autocratic • paternalistic • democratic • laissez-faire • situational	AO3

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CORE

Scientific and intuitive thinking/ management (HL only) AO2

Scientific thinking and management are based on objectivity, facts and empirical evidence. It follows a formal and prescribed procedure. Decisions are based on quantifiable data and proof rather than on subjective opinions, emotions, or intuition. The main benefit of scientific decision making is that decisions are made rationally and logically. This means that decisions are simpler to justify (as they are based on factual evidence) and easier to communicate to the staff. It can also reduce the risks involved in taking a particular decision.

By contrast, **intuitive thinking and management** is based on personal beliefs, perceptions and instincts or gut feelings. It considers issues that are not necessarily quantifiable, such as the impact of strategic decisions on the well-being of employees and the effects on the local community, or whether the decisions are morally correct. Intuitive decision making is quicker and less expensive than scientific decision making. As entrepreneurs are risk takers, they often have to make decisions based on their intuition. This might be due to a lack of time to collect and analyse the necessary data and evidence, or due to the information not being available. As the risks tend to be higher, only highly experienced managers tend to use this approach.

In reality, most decisions are based on a combination of both scientific and intuitive aspects. The business environment is dynamic in nature and decisions taken in the past that proved successful may not be so effective in the current environment or future situations. The choice of decision making depends on numerous factors, both scientific and intuitive. For example:

- Highly successful senior managers can make lots of intuitive decisions based on their acquired knowledge and past managerial experiences.
- Less experienced managers may, however, feel that they need evidence to support their decision making.

- The scale of the decision (strategic, tactical, or operational) is another factor. For instance, simple and routine decisions may not require any detailed analysis so using scientific thinking and management would be unnecessarily costly and time consuming.

The use of the Business Management Toolkit supports managers in their scientific thinking and management. These include quantitative tools such as decision trees (see Chapter 49) and critical path analysis (see Chapter 56), as well as qualitative tools, such as SWOT analysis (see Chapter 44) and business plans (see Chapter 48).

Theory of Knowledge (TOK)

Given the huge uncertainties that exist in the external environment, how important is the role of intuition in management decision-making?

CORE

Management and leadership (AO2)

"Management is doing things right; leadership is doing the right things."
- Peter F. Drucker (1909 - 2005), management consultant, educator and author

Human resource management

Mary Parker Follett (1868 - 1933) famously defined management as "*the art of getting things done through people.*" Management is essentially about problem-solving and decision-making, so involves a process of planning, organizing and coordinating resources to achieve organizational objectives. Therefore, **management** is the practice of achieving an organization's objectives by using and controlling the available human and non-human resources of the business in an effective way. A manager is someone with decision-making authority within an organization and has responsibility for problem solving in order to achieve specific organizational goals. Managers tend to focus on achieving specific organizational goals within a definite time frame. The functions of management are outlined in Box 9.1.

Box 9.1 - The functions of management

The term functions of management refers to the roles and responsibilities of managers. French economist Henri Fayol (1841 - 1925) identified five functions of management as shown in Figure 9.1.

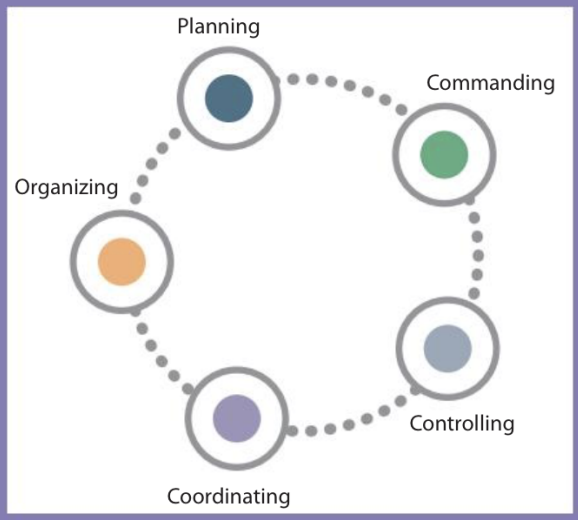

Figure 9.1 - The key functions of management

- *Planning* - Managers are responsible for setting the course of action to achieve organizational objectives. They are involved in setting tactical plans (short term plans) and may be involved in setting the organization's strategic plans (long term plans).
- *Commanding* - Managers give instructions and orders to their teams and subordinates in order to achieve business objectives. They should enforce discipline in the workplace to prevent slack and to prevent non-compliance.
- *Controlling* - Managers are responsible for the performance of their teams. Corrective measures should be taken if performance targets are not being met.
- *Coordinating* - Managers have the responsibility for ensuring that all departments strive to achieve the goals of the organization using the resources available.
- *Organizing* - Managers organize resources to achieve corporate objectives. This includes delegating or allocating tasks to workers and teams in order to ensure deadlines are met.



Figure 9.2 - A manager has decision-making authority

Leadership is the process of influencing, invigorating and inspiring others to achieve organizational goals. A leader is someone who influences and inspires others to get things done. A leader fosters motivation, respect, trust and loyalty from the workforce. Leaders tend to focus on achieving broader goals or visions, with no definitive time frame in mind.

The terms *management* and *leadership* are often used interchangeably because they serve similar purposes. At times, this is acceptable. However, there are some significant differences and it is important to consider these when referring specifically to either management or leadership:

- *Time and devotion* - Management is sometimes described as a '9am to 5 pm' job, whereas leadership is about being responsible 24-hours each day. Professor Warren Bennis (1925 - 2014) argues that managers have a short-term view whereas leaders have a much longer-term perspective. In essence, managers deal with tactical decisions whereas leaders handle strategic decisions.

- *Roles and responsibilities* - Leaders are accountable for a much broader range of roles and responsibilities. They deal with what and why questions, such as the strategic direction of the organization. Hence, leaders are creative and innovative thinkers. For example, Steve Jobs (1955 - 2011) constantly reminded his staff at Apple that they were "*changing the world*". By contrast, managers deal with routine *how* and *when* questions. They know how best to administer the day-to-day operations of a business. However, leaders know what the best thing is to actually do.

- *Influence on others* - Instructions and orders from managers are listened to because they come from an official position of authority. Leaders, however, inspire and motivate their followers through action and a vision. Leaders focus on people rather than concentrating on tasks. Hence, leaders are more socially engaged than managers. Bennis claims the key to competitiveness rests with the ability of leaders to generate *intellectual capital* (the skills and competencies of the workforce). This means that people can no longer be seen as resources that are simply managed as this would be "as difficult as herding cats" - a phrase that means it is impossible to manage the unmanageable. Instead, leaders inspire and entrust creative and talented people to help develop the organization.

- *Risk taking* - Managers follow predetermined rules and policies set by the organization. They tackle a particular task by keeping order and control, complying with company expectations and policies. Hence, their focus tends to be on accomplishing tasks. Leaders are more radical in their thinking. They take risks by challenging the status quo (the organizational and cultural norms) in order to move the organization forward.

- *Vision* - Some theorists argue that it is the vision that leaders have that ultimately separates them from managers. French emperor Napoleon Bonaparte (1769 - 1821) said that "*A leader is a dealer in hope*." Leaders create a culture of hope, getting people to where they have not been before, whereas managers abide by the procedures and culture of an organization. Managers can do well in familiar and secure business environments, but leaders are the ones who shine during times of crises and change.

Despite their differences (see Table 9.1), both management and leadership are essential for a business to be successful. It is possible for a manager to also be a leader (and vice versa), but this is not necessarily desirable. They provide different traits and strengths to enable an organization to meet its objectives.

Table 9.1 - Differences between the skills and roles of leaders and managers

Leaders	Managers
Do the right thing (sets goals)	Do things right (achieve goals)
Knowing what's right	Doing what's right
Asks *why*?	Asks *how*?
Motivating and inspiring others	Directing and controlling others
Empowering 'followers'	Delegating tasks to subordinates
People orientated	Task orientated
Create and foster a culture of change	Conform to organizational norms
Innovators	Implementers
Action	Position
Takes risks	Averts risks
Strategic decision-making	Tactical planning and monitoring
Respected by others	Listened to by others
Decisiveness	Analysis
Natural instincts	Learned skills

Exam tip !

Despite the distinction made between leaders and managers, they are not mutually exclusive given that the skills required to be an effective leader or manager are essentially the same. After all, managers have to lead their teams in order to achieve the strategic goals of the organization.

In essence, the differences between leadership and management can be explained by the differences in their characteristics, roles and outcomes. As Steve Jobs (1955 - 2011), co-founder of Apple said, "*Management is about persuading people to do things they do not want to do, while leadership is about inspiring people to do things they never thought they could.*" Nevertheless, large businesses in particular rely on the complementary roles of management and leadership to ensure the efficient running of their organizations.

ATL Activity 9.1 (Research and Thinking skills)

Identify someone in the media (such as a politician or business leader) who has demonstrated clear **ethical** principles in their leadership. Discuss his/her actions and the impact of their actions on others in society.

Key concept

How important is **creativity** for managers? Does this differ for leaders?

Leadership styles (AO3)

The following leadership styles: (i) autocratic, (ii) paternalistic, (iii) democratic, (iv) laissez-faire and (v) situational. AO3

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Leadership style refers to the ways in which decision makers behave or reveal their behaviour. There are five common styles of leadership specified in the syllabus:

(i) Autocratic

An **autocratic leader** is one who makes all the decisions and prefers not to delegate any responsibility. Instead, the autocratic leader (or the **authoritarian**) simply tells subordinates what to do, i.e. there is a clear chain of command. This leadership style is suitable in situations that require quick decision-making or when critical decisions have to be made, such as during a crisis or when dealing with a hostile takeover (see Chapter 5). This style is also appropriate when workers are inexperienced and unskilled, so are reliant upon the directions and instructions of leaders.

One drawback of an autocratic leadership style is that communication is top-down, so any opinions or suggestions of the workers are ignored. Leadership is often based on the personality of the leader. This can cause resentment amongst employees as they have little opportunity to make a real contribution. If an authoritarian culture exists, then employees become overly dependent on the leader and are unable to act on their own initiative. Hence, this leadership style can alienate and demotivate the workforce (see chapter 10), cause higher levels of staff absenteeism and increase the labour turnover rate.

Key concept

Do autocratic leaders necessarily suppress **creativity** in the workplace? Is it possible for creative employees to thrive under a system of autocratic leadership?

Case study 9.1 - Successful autocratic leaders

Steve Jobs (co-founder of Apple) and Ray Kroc (founder of McDonald's) were known to be autocratic leaders. Hollywood has made movies about these men, showing their drive for success and the way in which they handled people who dared to question their approach or vision.

- You can watch the trailer of Jobs (2013), starring Ashton Kutcher as Steve Jobs, here: https://goo.gl/LXgxMA.
- The trailer for The Founder (2016), starring Michael Keaton as Ray Kroc, can be viewed here: https://goo.gl/LfFFRe.
- What other examples of successful autocratic leaders can you find?

(ii) Paternalistic

Paternalistic leaders treat their employees as if they were family members by guiding them through a consultation process and acting in the best interest of their subordinates, even if the workforce does not always agree with the decisions made. Paternalistic leaders have exceptional organizational skills and build trust with their teams. There is close supervision which is an attempt to gain respect and acceptance from the workforce. There are two different types of behaviour depending on the perceptions or beliefs of the leader:

- A negative paternalistic style occurs when the leader perceives the workers as less than capable, so leads by supervision, guidance and control.
- A positive paternalistic style occurs when the leader perceives the workers as highly capable, so nurtures, supports and develops the workers.

Whichever approach is taken, the paternalistic leader acts in a fatherly (pater is Latin for 'father') manner to guide and protect the workers. The workers are expected to be loyal and obedient. This style of leadership has worked well in countries such as Japan and India where the cultural setting has enabled people to work hard due to respect and gratitude for their leaders. However, in other cultures and situations, this approach does not work well as workers do not necessarily want their perceived interests to be dictated by someone else - do parents always really know what is best for their children?(!) It is also inappropriate in organizations that have flatter, informal structures where creative thinking is required.



Figure 9.3 - Hyderabad, India, where a paternalistic style tends to work

(iii) Democratic

A democratic leader is one who involves employees in the decision-making process. They consult staff and consider their views before making any final decision. This participative leadership style means that decision-making is decentralized. Democratic leaders can bring about better morale and job satisfaction as employees are able to express their views and have some input into decision-making. The sharing of ideas can also lead to improved decisions. This leadership style might work more effectively if the leader cannot always be present to ensure that employees remain on task.

However, the main limitation of this approach is that it can delay decision-making because more people are involved in the process. Furthermore, such a style is not suitable when dealing with a very large workforce (as communication would be severely affected) or when there is a high dependence on clear leadership, such as dealing with trade union action such as an industrial strike (see Chapter 13) or a public relations crisis. Compromises are often made, but these are not always effective or optimal decisions.

Theory of Knowledge (TOK)

American psychologist William James (1842 - 1910) said *"The art of being wise is the art of knowing what to overlook"*. To what extent does this knowledge claim apply to the role of business leaders today?

Key concept

Discuss the role of democratic leadership in fostering **creativity** in business organizations.

(iv) Laissez-faire

Laissez-faire leaders are those who have minimal direct input in the work of employees. Instead, they allow subordinates to make their own decisions and to complete tasks in their own way. The leader sets the objectives, but it is up to employees to decide how best to achieve these using the resources available to them. This can cause high levels of motivation because the employees feel trusted and highly valued by their employer. Workers might feel that they have control over their work and can contribute to the success of the organization. This leadership style is suitable in businesses or situations where creativity is important, such as in computer software companies and advertising agencies.

A key limitation of laissez-faire leadership is that coordination and decision-making can be time-consuming as there is a lack of direct supervision or support. Hence, execution of business strategy can be prolonged, so this leadership style is unsuitable for businesses or situations that require quick and critical decision-making. It also relies heavily on teamwork and the goodwill of employees to achieve the organization's goals. Laissez-faire leadership might also encourage a degree of slack, i.e. people may be less proactive if they know they are not being directly monitored by senior management. After all, such a leadership style relies heavily on trusting workers to get their jobs done.

Question 9.1 - Vinayak Textiles



Vinayak Textiles is a clothing manufacturer that employs 230 people in Hyderabad, India. Wages at the business exceed the minimum wage in the city and workers have come to expect annual pay rises. The management team, who adopt a **laissez-faire leadership** approach, has expressed a desire to export the firm's products overseas to gain higher **sales revenue** and market share. However, mismanagement over the years has led to falling profits and lower competitiveness. Part of the problem is that many of the workers have become complacent, as there is very little supervision.

The new incoming Managing Director, Ritu Vinayak, has hinted at restructuring the organization. She intends to introduce a system whereby staff are remunerated based on meeting certain targets. Pay increments would no longer be a right, but a reward for improved performance.

(a) (i) Define the term *laissez-faire leadership.* *[2 marks]*

(ii) Define the term *sales revenue.* *[2 marks]*

(b) Explain the importance of effective management and leadership at Vinayak Textiles. *[6 marks]*

Common mistake

Students repeatedly write in the exams that laissez-faire leadership is 'good' whilst autocratic leadership is 'bad', without any substance or justification. You should avoid writing such subjective comments. There are circumstances when autocratic leadership is preferred to a laissez-faire approach, such as during a crisis or when dealing with imminent deadlines.

Theory of Knowledge (TOK)

In the highly competitive world of business, is trust irrational?

(v) Situational leadership

Situational leadership is a leadership style that, unlike the others above, is not based on any single dominant approach. In essence, it is about using the right leadership style for the right situation. As Mahatma Gandhi (1869 - 1948) said, "*Leadership at one time meant muscles, but today it means getting along with people.*" For example, a crisis requires a more autocratic leadership style whereas a laissez-faire approach can be ordinarily adopted by the same leaders who have highly skilled and empowered staff.

Situational leadership also suggests that leaders must be able to change and adapt their style to different situations. 'CLOTS'® is a useful acronym for remembering the factors that can affect situational leadership styles:

- **C**ulture - What type of culture exists within the organization and what are the group norms?
- **L**eader - How much trust do leaders have in their employees, how experienced and confident are they as leaders and what is their preferred (or natural) leadership style?
- **O**rganizational structure - Is the organizational structure tall (hierarchical) or flat? How large is the leader's span of control?
- **T**ask - To what extent are the tasks difficult, urgent and important? Are the tasks routine and low skilled or are they highly complex?
- **S**ubordinates - What are the level of skills, motivation and unity of the employees? How many employees are there in the organization?

- Warren Bennis (1925 - 2014), who devoted all of his professional life to the qualitative study of leadership, showed that leaders find their own style that suits them best. Although they may have a natural or preferred style, it is unlikely that effective leaders will use a single style because different situations require them to adapt. This will depend on several factors such as:

- The traits, personality and experiences of the leader.
- The level of skills, experience, motivation and confidence of the employees.
- The time frame under consideration, i.e. how quickly decisions need to be made.
- The nature of the task, such as whether the task is routine, complex, or a crisis.
- The degree of importance of the decision, such as whether it is a tactical or strategic decision.

CORE

Question 9.2 - Situational leadership (1)

Explain which form of leadership style might be most appropriate for the following organizations.

(a) A small local restaurant with 12 employees. *[4 marks]*

(b) The armed forces (military). *[4 marks]*

(c) A large IB World School that offers the IB Diploma Programme. *[4 marks]*

Theory of Knowledge (TOK)

What is more important in management decision-making: reasoning, intuition, or emotion?

Business Management Toolkit

How might knowledge of Hofstede's cultural dimensions (see Chapter 54) help to improve the effectiveness of management and leadership in business organizations?

Theory of Knowledge (TOK)

To what extent should equity (fairness) inform business decision-making?

Question 9.2 - Situational leadership (2)

With reference to situational leadership, explain how the following cases should be handled by an effective leader.

(a) Yoann is seeking permission to take 2 weeks off work to look after his father who is critically ill. *[4 marks]*

(b) Kiran has become highly demotivated so is not putting in much effort, causing huge concerns for her team. *[4 marks]*

(c) Monisha has complained that her line manager is using bullying tactics and is not observing the equal opportunities policy of the organization. *[4 marks]*

Question 9.3 - School leadership and management



A secondary (high) school is typically led by a Principal (the Head teacher), supported by a senior **leadership** team. Middle managers are recruited to fill job roles such as Heads of Department and Heads of Year. There might also be a Business Manager, who is in charge of administering the non-teaching aspects of a school, such as buildings maintenance and the **management** of non-teaching staff

(a) (i) Define the term *leadership*. *[2 marks]*

(ii) Define the term *management*. *[2 marks]*

(b) Comment on how the roles of a manager and a leader differ in organizations such as schools. *[4 marks]*

(c) Discuss how different management and leadership styles can influence the level of staff motivation in organizations such as schools. *[10 marks]*

Leadership, management and the key concepts

Ethical considerations of leadership and management are based on people's personal values and moral judgements, which in turn determine the extent to which leaders and managers accept responsibility for ensuring the ethical conduct of business activities. Due to the changing external pressures for businesses to act in a socially responsible manner (see Chapter 3), there is growing scrutiny of business activities. Thus, leaders and managers are increasingly focusing on ethical considerations in their actions and decision-making as well as the ways in which they influence others.

Ethical leadership involves authentic empowerment of the workforce. This also frees up time for leaders and managers to fulfil other strategic responsibilities. Note, however, that not everyone is suitable or wants to take on extra responsibility. Also, leaders and managers still retain overall accountability for the delegated work, so still need to monitor the progress and work of their subordinates and teams. The Chinese proverb "*talk does not cook rice*" suggests that managers and leaders, irrespective of the organizational culture, must set an example by their actions, rather than through talk or position alone. Albert Einstein (1879 - 1955) said that "*Setting an example is not the main means of influencing another; it is the only means*".

The leaders and managers of an organization have a direct effect on the levels of morale, commitment and competence in the workplace. In turn, this affects the productivity and profitability of the organization. Hence, it is vital that any business strategy considers effective leadership and management, especially when implementing changes to the organization.

The trend for modern organizations is a shift away from autocratic leadership, as advocated by the likes of Henri Fayol and Frederick W. Taylor (see Chapter 10), towards a more democratic style of leadership, that enables creativity to flourish. However, this does not imply that organizations cannot thrive under a more authoritarian leadership system. Nevertheless, research from the likes of the Organization for Economic Co-operation and Development (OECD) suggests that effective managers and leaders have been observed to trust their staff by delegating responsibility and empowering people rather than micro-managing their work.

Modern management and leadership practices see employees having a role in the decision-making process. Mahatma Gandhi (1869 - 1948) said "*I suppose leadership at one time meant muscles; but today it means getting along with people*". This is not seen as a weakness of leaders but an amplification of their ability to lead others in an ever-changing business world where the skills of creativity and service to others are increasingly more important.

Theory of Knowledge (TOK)

Are paternalistic leaders more ethical than those who adopt an autocratic, democratic or laissez-faire style?

Key concept

The OECD Skills Outlook 2022 Report shows that "creativity, originality and initiative" are amongst the most important 21st century job skills needed for the future of work. Similarly, **creativity** was the top skill revealed in LinkedIn's extensive data set collected throughout the COVID-19 pandemic to identify the skills that companies need most.

CORE

ATL Activity 9.2 (Thinking skills)

Effective leaders and managers need to have certain qualities to succeed. Discuss how the IB Learner Profile links to entrepreneurial qualities that make leaders and managers effective in their roles.

ATL Activity 9.3 (Research and Thinking skills

Leadership styles can vary across national and regional cultures. Read the insightful BBC article (http://goo.gl/Px1HJP) about the CEO of Haier, China's consumer electronics giant. To what extent do you think the 'sledgehammer' and 'catfish management' approaches to leadership would work in your own country or for another country of your choice?.

Human resource management

Business Management Toolkit

The preferred style of a leader depends on several factors including cultural styles of leadership. Hofstede's cultural dimensions (see Chapter 54) provides greater insight into how culture influences leadership. Hofstede investigated the links between international cultures and organizational cultures, concluding that people in different cultures expect different things from leaders. For example, a consensus model of leadership is found in countries like Japan and the Netherlands where group decision-making is the norm. By contrast, the charismatic model of leadership is observed in other countries such as the UK, USA or Australia where there is a tradition and expectation that leaders make decisions with decisiveness and transparency. Hofstede's findings suggest that knowledge and understanding of such differences can largely affect how managers and leaders behave in cross-cultural situations.



Figure 9.4 - Culture, traditions and norms have a direct impact on leadership styles

Theory of Knowledge (TOK)

To what extent do leaders and managers always know what is 'best'?

Key concept

Discuss the extent to which **ethics** and **change** influence leadership styles in business organizations.

REVIEW QUESTIONS

1. What is scientific thinking and management?
2. What is intuitive thinking and management?
3. What is the main advantage of scientific thinking and management?
4. What is the main advantage of intuitive thinking and management?
5. How does 'management' differ from 'leadership'?
6. What are the main functions of management?
7. What are the main differences between leaders and managers of an organization?
8. What is meant by an autocratic leadership style and when might it be suitable?
9. What is meant by a paternalistic leadership style and when might it be suitable?
10. What is meant by a democratic leadership style and when might it be suitable?
11. What is meant by a laissez-faire leadership style and when might it be suitable?
12. What is meant by a situational leadership style and when might it be suitable?
13. What are the five factors that affect situational leadership styles? (Hint: think of the mnemonic 'CLOTS').
14. How do cultural differences affect leadership style?
15. How do ethical considerations affect leadership style?

KEY TERMS

Autocratic leadership refers to leaders who adopt an authoritarian approach by making all the decisions rather than delegating any authority to their subordinates. Instead, the autocratic leader simply tells others what to do.

Democratic leadership refers to the leadership approach that considers the views of others when making decisions. This participative leadership style means that decision-making is decentralized.

Functions of management refers to the roles of managers, namely the planning, organizing, commanding, coordinating and controlling of business operations.

Intuitive thinking and management are based on personal beliefs, perceptions and instincts or gut feelings. This approach to management and leadership considers issues that are not necessarily quantifiable.

Laissez-faire leadership is an approach based on having minimal direct input into the work of employees. Instead, laissez-faire leaders allow subordinates to make their own decisions and to complete tasks in their own way.

Leadership is the skill of getting things done through other people by inspiring, influencing and invigorating them to achieve organizational goals.

Leadership style refers to the ways in which decision makers behave or reveal their behaviour. These styles or approaches are categorized as autocratic, paternalistic, democratic, laissez-faire or situational.

Management is the practice of achieving an organization's objectives by using and controlling the available human and non-human resources of the business in an effective way.

A **manager** is someone with decision-making authority within an organization and has responsibility for problem solving in order to achieve specific organizational goals.

Paternalistic leaders treat their employees as if they were family members, guiding them through a consultation process and acting in the perceived best interest of their subordinates.

Scientific thinking and management are based on objectivity, facts and empirical evidence. This approach to the management and leadership follows a formal and prescribed procedure.

Situational leadership refers to the approach that considers there is no single leadership style that suits all situations. The optimal style depends on situational factors, such as the attitudes, behaviour, and competencies of managers and workers.



Figure 9.4 -Scientific thinking and management is based on data and evidence

Chapter 10

Unit 2.4 - Motivation and demotivation

"If you think you can do a thing or think you can't, you're right."
- Henry Ford (1863 - 1947), Founder of the Ford Motor Company

Contents

2.4 Motivation and demotivation	
SL/HL content	**Depth of teaching**
The following motivation theories: • Taylor • Maslow • Herzberg (motivation-hygiene theory)	AO3
The following motivation theories: • McClelland's acquired needs theory (HL only) • Deci and Ryan's self-determination theory (HL only) • Equity and expectancy theory (HL only)	AO3
Labour turnover (HL only)	AO2, AO4
The following types of appraisal: (HL only) • Formative • Summative • 360-degree feedback • Self-appraisal	AO2
Methods of recruitment (HL only)	AO2
Internal and external recruitment (HL only) Salary	AO3
The following types of financial rewards: • Wages (time and piece rates) • Commission • Performance-related pay (PRP) • Profit-related pay • Employee share ownership schemes • Fringe payments	AO2
The following types of non-financial rewards: • Job enrichment • Job rotation • Job enlargement • Empowerment • Purpose/the opportunity to make a difference • Teamwork	AO2
The following types of training • Induction • On the job • Off the job	AO2

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Motivation theories (AO3)

The following motivation theories: (i) Taylor, (ii) Maslow and (iii) Herzberg (motivation-hygiene theory).

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Motivation refers to the desire, effort and passion to achieve something. It is the willingness to complete a task or job with intent and purpose. The UK Institute of Management defines motivation as "*getting someone to do something you want or, on an individual basis, wanting to do something for yourself for a particular reason.*"

Many businesses argue that people (human resources) are their most valuable (and expensive) asset. Therefore, such businesses seek to get the most out of their human resources by using appropriate methods of motivation. Motivation theory looks at how managers seek to motivate their workforce to maximise job satisfaction, staff morale and labour productivity. Businesses need to understand what motivates people in order to achieve their organizational objectives. Box 10.1 outlines some of the benefits of having a motivated workforce. By contrast, a demotivated workforce will hinder the performance of a business. Signs of poor motivation are summarised in Box 10.2.

CORE

Human resource management

Box 10.1 - Generic benefits of increased worker motivation

- Higher staff morale and job satisfaction (which leads to higher productivity and quality)
- Better industrial relations (reduces the chances of conflict in the workplace)
- Lower absenteeism (staff have incentives to turn up to work)
- Lower staff turnover (reduces the costs of replacing staff)
- Improves corporate image (helps to attract customers and potential employees)
- Higher profitability (generated from combining the above benefits).

Box 10.2 - Warning signs of poor motivation in the workplace

- High absenteeism rate (percentage of workforce that miss work without valid reasons)
- High labour turnover rate (number of staff who leave as a percentage of the total workforce, per year)
- High wastage level (a high percentage of defective output or substandard work)
- High number of customer complaints (due to the poorer quality output and a lack of customer service)
- Low quality output (workers are more likely to make mistakes and care less about quality)
- Poor punctuality (poor timekeeping and missed deadlines)
- More disciplinary problems (corrective measures required to deal with less productive staff).

Theory of Knowledge (TOK)

What knowledge issues arise when attempting to measure the level of staff motivation in an organization?

Motivation theories

The following motivation theories are specified in the syllabus: (i) Taylor, (ii) Maslow and (iii) Herzberg (motivation-hygiene theory).

(i) Taylor (1911)

Frederick Winslow Taylor (1856 - 1915), an American engineer and inventor, advocated the use of piece-rate payment systems suggesting that "*what the workmen want from employers beyond anything else is higher wages.*" Taylor's **principles of scientific management** assumed that employees are primarily motivated by money and that productivity could be improved by setting output and efficiency targets related to pay.



Figure 10.1 - According to Taylor, nothing motivates workers more than pay

Taylor believed it was a manager's duty to decide how each and every individual task should be completed, i.e. it was the manager's role to plan, direct and control. He suggested that "*In the majority of cases, man deliberately plans to do as little as possible*" and that factory workers were ill-equipped to plan their own work but only sought to maximise their personal reward from work. Hence, Taylor promoted the use of **division of labour** (breaking down different aspects of a job or task and assigning different people to each particular part of the work), thus specialising in the production process to improve efficiency and output.

Taylor also advocated the use of **differentiated piecework** whereby workers are paid a standard level of output and receive a higher rate of pay if they exceed that benchmark. Essentially, it is an incentive scheme that rewards more productive workers. Taylor suggested that workers ought to be scientifically selected for jobs, based on their abilities, rather than managers subjectively making decisions based on their perceptions or opinions of potential employees.

Taylor's theory of scientific management was highly influential in the 1920s. It was most famously adopted by Henry Ford who used conveyor belt technology to mass produce his Ford Model T cars. Today, McDonald's still uses a system of scientific management. Its catering procedures, such as cooking temperatures and cooking times, are the same all over the world. McDonald's even has its own university to ensure that senior managers are trained to perform their tasks in exactly the same way, wherever they work in the world. It is the managers who routinely inspect production processes in their restaurants to ensure that things run smoothly. Waged staff are paid using a differentiated piecework system and have no direct input into how things are done.

Taylor's theory has been criticised for ignoring the *non-physical* contributions of workers. It can be difficult to measure physical output in some professions, such as teaching and healthcare. Hence, scientific management is rather ineffective when referring to jobs that focus on mental rather than physical output. Subsequent studies have also shown that people are not only and simply motivated by money. Taylor's theory ignored *non-financial factors* that motivate people. Taylor also failed to acknowledge that workers can be innovative and independent thinkers. Due to higher levels of educational attainment in modern societies, workers do not simply want to be told what to do but prefer to have a say in how things are done. A final criticism is that scientific management can entail repetitive and monotonous tasks, thereby leading to job dissatisfaction. Although it rewards hard work, employees do not necessarily feel that the financial compensation is sufficient relative to the drawbacks of such a system.

Nevertheless, Taylor's research on how to increase productivity and efficiency levels has stood the test of time. Introduced in the early twentieth century, Taylor's work proved to be highly influential and relevant to businesses at the time. Taylor assumed that people are rational (sensible) so would work harder if they were better paid. American firms introduced mass production and employed low skilled migrants who were probably most interested in the pay. Today, many businesses throughout the world still use Taylor's approach. The culture, values and beliefs of relatively low paid workers in Pakistan, Vietnam and Indonesia make it ideal to use scientific management.



Figure 10.2 - Vietnam's culture is ideal for scientific management

Theory of Knowledge (TOK)

Given the existence of different cultural dimensions, what do we actually know about what actually motivates different people?

(ii) Maslow (1943)

American psychologist Abraham Maslow (1908 - 1970) focused on the psychological (emotional and mental) needs of workers as he believed people are motivated by more than just their pay. He suggested that people would need to be satisfied with their lower level needs before they could progress to higher level needs. For example, a person suffering from hunger (physiological needs) would not worry about trying to gain recognition (esteem needs). Maslow's **hierarchy of needs** revealed five levels of needs:

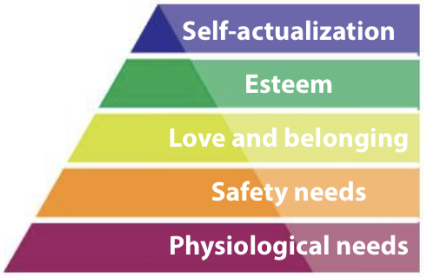

Figure 10.3 - Maslow's hierarchy of needs

1. **Physiological needs** (or **basic needs**) are the needs that must be met for people to survive, such as water, food, air, warmth and sleep. In business terms, the amount of money workers earn determines the extent to which they are able to meet these basic needs.

2. **Safety needs** (or **security needs**) are the demands necessary to make people feel safe and stable. Security needs include predictability (daily structure and routine) and order (protection from harm). For example, businesses can provide job security, sick pay, maternity leave and pensions (retirement income) to meet their workers' security needs.

3. **Love and belonging needs** (or **social needs**) refer to the human desire to be accepted as part of a friendship group or a family. It is human nature to want to be loved and accepted by others. These needs can be satisfied by improved communications, social gatherings and other opportunities to be with people. Business applications of social needs include opportunities to work in teams as well as compliance with anti-discrimination laws (which helps to promote a sense of worth and belonging at work).

4. **Esteem needs** refer to the desires for recognition and self-respect. *Internal esteem needs* indicate that people need to feel good about themselves (perhaps from a sense of achievement) whereas *external esteem needs* signify the desire for recognition by others (such as having status and recognition at work). As Henry Ford (1863-1947) said "*there is no happiness except in the realisation that we have accomplished something*." Job titles, such as 'Regional Director', can help to boost internal and external esteem needs. Schemes such as 'employee of the month' may or may not come with a financial reward, but for many people the recognition is more important than any monetary incentive. Sincere praise and positive reinforcements can also address these needs. Internal promotion, rather than recruiting someone from outside the organization, can improve staff morale as this shows that employers have faith in the existing workforce. Training and development opportunities might also suggest that the organization values its employees.

Case study 10.1 - Charle Co.

Charle Co., a Japanese wholesaler of women's underwear with a workforce of over 320 people, pays for an all-expenses annual visit to one of Disneyland's theme parks (including flights, entrance tickets and hotel costs). This is in recognition of the contributions of the company's workers during the year.

5. **Self-actualization** is the highest level in Maslow's hierarchy of needs. It refers to the forces that drive people to become the best that they can be. Businesses can encourage this by providing opportunities for professional development and promotion. Maslow argued that people who achieve self-actualization are democratic in their outlook because to reach self-fulfilment a person must have the freedom over what they do to exploit their talents and in a way that only they know best. Maslow explained this by saying "*A musician must make music, an artist must paint, a poet must write, if he is to be ultimately happy*."

In reality, it might not be feasible for a business to motivate all workers up the hierarchy of needs. For example, it might be more realistic to satisfy only physiological and security needs of workers in a large factory, fast-food chain or supermarket. It might be more appropriate to concentrate on meeting the higher level needs of core staff such as senior managers. Critics of Maslow's hierarchy of needs also claim the following limitations:

- Levels of needs are somewhat difficult to measure. Maslow was a psychologist and not a scientist, mathematician or entrepreneur. How accurately can businesses really measure and quantify the level of security, esteem and love or belonging in the workplace?

- Maslow assumed that everyone is motivated in the prescribed and chronological order in his model. However, do freelance artists and writers or volunteer workers fit this model? Homeworkers, authors, artists and self-employed drivers do not get the social interaction of working in an office, but this does not mean they cannot be highly motivated. Some people are willing to sacrifice pay and benefits for better working conditions and job security. Indeed, subsequent studies such as by the Minneapolis Gas Company from 1945 to 1965 found that people placed security needs as their number one motivator. These extensive studies revealed that advancement, the type of work and being proud of working for the company were the next three key motivators (the latter two do not feature in Maslow's model).

- There is no explanation of what motivates people once they have achieved self-actualization. What drives those who have perhaps already reached self-actualization, such as the likes of Elon Musk, Jeff Bezos or Bill Gates? What motivates them to continue in their lines of business if they have already achieved so much in their prolific careers? What encourages wealthy people who are past retirement age (such as Warren Buffet and Larry Ellison) to continue working?

Exam tip !

One way to remember Maslow's hierarchy of needs is the 5S model: survival (basic or physiological) needs, security (safety) needs, social needs, self-esteem and self-actualization.



Question 10.1 - The world's richest billionaires

	Billionaire	Net Worth (US$bn)	Company
1.	Elon Musk	$278	Tesla and Space X
2.	Jeff Bezos	$202	Founder and Executive Chairman of Amazon
3.	Bernard Arnault	$170	CEO of LVMH (Louis Vuitton Moët Hennessy)
4.	Bill Gates	$137	Co-founder of Microsoft
5.	Larry Page	$131	Co-founder of Google
6.	Sergey Brin	$126	Co-founder of Google
7.	Mark Zuckerberg	$121	Co-founder and CEO of Facebook
8.	Steve Ballmar	$119	Former CEO of Microsoft
9.	Larry Ellison	$109	Co-founder and CEO of Oracle (software)
10.	Warren Buffett	$104	CEO of Berkshire Hathaway (conglomerate)

Source: adapted from *Forbes* magazine The Richest People in the world (2022) (www.forbes.com/billionaires)

(a) Define the term *motivation.* *[2 marks]*

(b) Applying the theories of Taylor and Maslow, examine whether people are motivated simply by money. *[6 marks]*

(c) Discuss the factors that motivate some people to continue working despite their age or their wealth. *[10 marks]*

CORE

Human resource management

(iii) Herzberg (1959)

Frederick Herzberg (1923 - 2000) investigated the factors that caused satisfaction and dissatisfaction at work. Professor Herzberg focused on the sociological and psychological aspects of work. His research was conducted by a series of interviews with accountants and engineers that resulted in two categories of factors affecting the level of motivation in the workplace: *hygiene factors* (mainly physical aspects) and *motivators* (mainly psychological aspects) - refer to Table 10.1.

Hygiene factors (or **maintenance factors**) are aspects of work that do not motivate but must be met to prevent dissatisfaction. These factors must not fall below the level considered to be acceptable by the workforce or society as a whole. Essentially, they are the factors that meet people's basic needs.

Herzberg cited organizational rules, regulations, policies, supervision, working conditions and pay as examples of hygiene factors. So, for example, a business that pays less than the average wage rate in the industry, offers no job security and has poor working conditions will have a negative impact on its employees. Interestingly, Herzberg argued that a pay rise does not in itself motivate as workers can come to expect further pay rises in the future. He suggested that hygiene factors become an expectation and are taken for granted, such as employer contributions to the pension funds of their workers. Hence, maintenance factors do not motivate employees to work any harder.



Figure 10.4 - Rules, regulations and policies are hygiene factors

Motivators are factors that can lead to the psychological growth of workers and hence increase satisfaction and performance at work. Herzberg showed that achievement, recognition, responsibility and advancement of the worker lead to increased worker satisfaction. He argued that the use of motivators would help to improve the nature and contents of a job.

Herzberg advocated that firms ought to motivate employees by using a democratic leadership style (see Chapter 9). He argued that businesses should train employees to perform tasks that they were not capable of doing when they were recruited. He suggested that managers could achieve this, thereby improving employee motivation, through three key areas:

- **Job enlargement** involves giving workers more variety in what they do, thus making the work more interesting. This does not necessarily mean that the work is any more challenging.

- **Job enrichment** involves giving workers more complex and challenging tasks to exploit their potential. This should contribute to workers feeling a greater sense of achievement.

CORE

Human resource management

Table 10.1 - Herzberg's motivators and hygiene factors

Hygiene factors (job context - causes of dissatisfaction)	**Motivators (job content - causes of satisfaction)**
• Job security	• Achievement
• Organizational policies, rules and regulations	• Advancement
• Pay - salaries and wages	• Interesting tasks
• Physical security	• Opportunities for promotion
• Physical working conditions	• Personal growth
• Relationship with peers, subordinates and supervisors	• Recognition
• Status	• Responsibility
• Supervision and coordination	• Work itself

- **Job empowerment** entails delegating decision-making authority to workers over their areas of the job, helping to boost their overall level of morale.

Herzberg also looked at the crucial difference between what he called 'movement' and what he understood to be 'motivation'. **Movement** occurs when people do something because they *need* to, perhaps because it is part of their job, so they feel obliged to do so. Hence, movement is an extrinsic incentive. By contrast, **motivation** happens when people do something because they *want* to, i.e. it is based on intrinsic reasons. Unlike other theorists who believed that people are motivated mainly by financial rewards, Herzberg felt that workers are motivated by being responsible for their work, i.e. the work itself can be rewarding.

Herzberg's theory allowed managers to think in a different way from previous motivational theorists such as Taylor and Maslow. The existence of hygiene factors meant it might be better for managers to ensure that workers are not demotivated, rather than hypothesising what might motivate them. Herzberg's arguments also presented problems for managers as he claimed that individuals are unique and therefore what motivates one worker does not necessarily motivate others. Furthermore, people's moods and priorities affect their level of motivation, so what motivates someone today does not necessarily motivate the same person tomorrow.

Critics of Herzberg's two factor (motivation-hygiene) theory argue that it does not apply to many occupations, especially those in low-skilled and low-paid jobs, where job enrichment and empowerment are not features of their work. He used professional workers and skilled engineers in his research sample, so the findings might not be representative of other workers. Moreover, some employees may not want enriched jobs as this involves extra responsibility and the burden of more stress.

Theory of Knowledge (TOK)

How can we possibly know the true meaning of a motivation theory if the theorist (such as Taylor, Maslow, or Herzberg) is no longer alive?

Question 10.2 - Richer Sounds

Julian Richer (born 1959) is the Managing Director and founder of Richer Sounds, the UK's largest hi-fi and home entertainment retailer. In 1978, aged just nineteen, Richer opened his first store in London Bridge. The company has more than 50 retail outlets throughout the UK. In 1994, Richer's flagship store in London Bridge set a new Guinness World Record for the highest sales per square metre of any retail outlet in the world - a staggering £195,426 ($322,450) per square metre - a record which the company still holds today.

Richer Sounds has also won many awards, including the *Which?* magazine's Best Retailer Award and *The Sunday Times* award for Britain's best employer. The company is also one of the UK's most generous donors, allocating 15% of its annual profits to charitable organizations.

Julian Richer believes it is vital that his employees 'have fun' and enjoy their work. He is renowned for **job empowerment** of his staff. Each week, he looks at employee suggestions and awards up to £20,000 ($28,000) for an idea. Each month, the top three salespeople get to use one of his personal Bentley or Rolls-Royce cars for a weekend. He only promotes people internally. Richer argues that businesses with demotivated staff face lower productivity due to higher absenteeism, labour turnover, theft and customer complaints.

Sources: www.richersounds.com/the-richer-way and The Richer Way, by Julian Richer

(a) Define the term *job empowerment*. *[2 marks]*

(b) Explain how motivation can lead to improved labour productivity at Richer Sounds. *[4 marks]*

(c) Examine how the opinions of leaders, such as Julian Richer, can affect the successful implementation of motivation in the workplace. *[6 marks]*

HIGHER LEVEL

The following motivation theories are also stated in the syllabus for HL students: (i) McClelland's acquired needs theory, (ii) Deci and Ryan's self-determination and (iii) equity and expectancy theory.

(i) McClelland's acquired needs theory (1961) (HL only)

American psychologist David McClelland (1917 - 1998) put forward the **acquired needs theory** (also known as the **learned needs theory**). From his study of 500 managers working in 25 American companies, McClelland acknowledged that managing a group of people with different personalities and varying needs can be challenging. From his studies, McClelland concluded in his book, "The Achieving Society" (1961) that three types of needs must be satisfied to boost motivation and productivity, regardless of people's gender, culture or age:

1. **Need for Achievement (n-Ach)**. McClelland found that achievement-motivated people tend to be moderate risk takers. Low risk activities are too easy to accomplish so n-Ach people do not feel they have genuinely achieved anything. They do not take high risks either as the outcome is largely based on chance and luck, rather than through their own efforts. These people also prefer to work on tasks where they hold key responsibilities or work alongside high achievers. They are more interested in personal success rather than extrinsic rewards that recognise their achievements. This could mean that n-Ach people prefer not to delegate tasks. They also tend to self-reflect on their performance in order to find ways to further improve. McClelland suggested that the major causes of n-Ach are parental influences, cultural factors and educational experiences.

2. **Need for Power (n-Pow)**. Power-motivated people like to influence the behaviour of others so tend to be very strong-willed. Power can take two forms: personal or institutional. Those who seek *personal power* do so to pass on instructions or orders to others. Perhaps this makes the person feel more important, but it often makes others resent the individual who is seen by others as simply 'bossy' or even a 'power freak'. Staff will have to do as they are told, irrespective of whether they agree with the n-Pow person or not. By contrast, people who have *institutional power* strive to make others work harder in order to achieve organizational objectives. They use their authority to try and bring out the best in their teams. Hence, McClelland argued that these people are more likely to be successful. He also suggested that good leaders need to have at least moderate n-Pow as leadership is about influencing the behaviour of others.

3. **Need for Affiliation (n-Aff).** People who need affiliation seek to have a good social and working relationship with colleagues and the senior management team. This makes them happier at work, thereby increasing their motivation and productivity. Such people tend to conform to group norms and avoid conflict in order to be accepted as part of a group. Unlike n-Ach people who may prefer to work alone, n-Aff people favour opportunities for social interactions, such as teamworking or customer relations.

McClelland believed that these three needs are present in all people although the relative intensity of each one varies from person to person. He helped to provide insight into how people with different kinds of needs are motivated in different ways. Managers who are aware of these acquired needs and how they affect employees can allocate jobs and tasks more suitably to boost motivation and productivity.

In summary, employees with high n-Ach ought to be given challenging but achievable tasks. People with high n-Pow could be given opportunities to manage and lead different teams of people. Finally, those with n-Aff should be provided with a cooperative and collaborative working environment to gain their best performance.

ATL Activity 10.1 (Thinking skills)

To what extent do you think that McClelland's theory of motivation applies in the context of the country you currently live in?

(ii) Deci and Ryan's self-determination (1985) (HL only)

Self-determination theory is the work of American psychologists Edward L. Deci (b.1942) and Richard M. Ryan (b.1953). They describe motivation as what moves or makes people to act. Self-determination theory (SDT) examines the fundamental and positive human tendency to grow (flourish). Deci and Ryan introduced their SDT theory in their book "Self-Determination and Intrinsic Motivation in Human Behaviour" (1985), which outlines three core requirements that facilitate such growth: autonomy, competence and relatedness.

- *Autonomy* – This refers to the need or drive to have control over what a person does. When this need is satisfied, the person feels a sense of integrity and authenticity with their actions and decisions. When the need for autonomy is not met, the person feels frustrated, pressurized and pushed in an unwanted direction.

- *Competence* – This refers to the need or drive to feel confident and competent in doing a particular task or job role. It is about a sense of effectiveness, value and mastery. Competence can be achieved through providing and developing opportunities to use and extend people's skills and expertise. When this need is not met, the person experiences a sense of ineffectiveness, vulnerability and failure.

- *Relatedness* – The refers to the need to interact, be connected to and experience caring for others. This need is met when people feel they have meaningful relationships and interactions with others, as well as feeling significant to others. If the need for relatedness is not met, people feel a sense of social alienation, exclusion and loneliness, all of which have a detrimental impact on motivation and productivity.

Self-determination theory focuses on intrinsic motivation, which is intangible and internal to an individual, such as a sense of recognition, purpose and achievement. Deci and Ryan's SDT concept suggests that these three needs or drivers of motivation are essential for intrinsic motivation because they help people to feel engaged, fulfilled and valued. The theory can help employers to gain a better understanding of how best to develop and engage their workforce as well as help individual employees to better understand how they can be more successful in their profession.

Deci and Ryan argue that work (employment) has the potential to be a catalyst for meaningful growth, both personally and professionally. Developing self-determination through autonomy, competence and relatedness positively impacts for the individual and society as a whole.

Key concept

How important is the role of **creativity** in promoting intrinsic motivation in the workplace?

(iii) Equity and expectancy theory (HL only)

John Stacey Adams's **equity theory** (1963) suggested that workers will naturally compare their efforts or rewards to those of others in the workplace (subordinates, peers and superiors). Each worker should receive a remuneration package (salary plus fringe benefits) that reflects their efforts. The degree of equity (perceived fairness) in an organization is based on the ratio of *inputs* (contributions made by the employee) to *outputs* (financial and non-financial rewards).

Typical inputs include expertise, experience, enthusiasm and effort. Inputs can be physical and intellectual. Outputs (also referred to as outcomes) typically include remuneration, recognition (praise), rank (status) and responsibilities. Outputs can be both tangible and intangible.

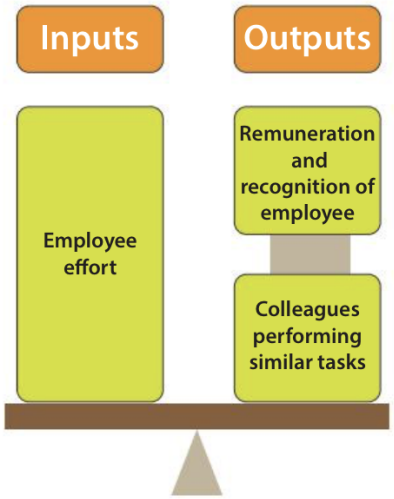

Figure 10.5 - Equity exists when inputs and outputs balanced

Adams argued that workers will only be motivated if their input to output ratio is deemed to be equitable (fair) in relation to that of others in the workplace. He suggested that the degree of equity in the workplace has a direct impact on the level of motivation on three levels:

- *Equity norm* - Workers expect an equitable remuneration package for their contributions in the organization. Adams proposed that businesses should strive to ensure staff perceive equity throughout the organization (see TOK question below regarding the gender pay gap).

- *Social comparison* - Workers determine what is fair based on comparisons of their inputs and outputs with those of their peers (co-workers). Inequities exist if those who put in relatively more effort (or have to contribute more as part of their job) are paid comparatively less.

HIGHER LEVEL

- *Cognitive distortion* - Workers who feel under-compensated (inputs are greater than outcomes), become dissatisfied and demotivated so might withdraw any goodwill. They can seek a balance by altering their inputs (such as putting in less effort) and/or outcomes (such as negotiating a pay rise).

Theory of Knowledge (TOK)



According to a recent report from the Institute for Fiscal Studies (IFS) published in 2021, government policies have made almost no difference to the gender pay gap in the UK for 25 years since 1995. The IFS found that women are less likely to be in paid employment, work 8 fewer hours than men per week and are paid 19% less per hour on average than men. The IFS compared official earnings data for more than 2 million people aged 20 to 55 for the period between 1995 and 2019.

Is it ethical for there to be a gender pay gap? Does time make any difference to this matter?

Exam tip !

To contextualise equity theory, consider how you might feel if your teacher gives you a lower predicted grade for Business Management despite you putting in a huge amount of effort, yet your friend who has put in very little effort is given a higher predicted grade from the same teacher.

If inequities are not dealt with, absenteeism will increase and workers can become disruptive to the organization. In severe cases of inequities, workers might even take industrial action (see Chapter 13) or resign from their jobs. Therefore, an equitable balance in the ratio of inputs to outputs means workers should have greater satisfaction and motivation in their jobs, helping to ensure positive, productive and professional relationships at work.

However, critics of equity theory point out that the concept of fairness is highly subjective. Two people with the same qualifications and skills, performing the same jobs for the same remuneration package might have very different perceptions of what is 'fair'. Some people are more sensitive to issues of equity than others; the theory ignores demographic, psychological and cultural factors that can affect perceptions of fairness.

Furthermore, whilst workers can accept that senior staff are compensated more, there is a limit to the scales of equity so it can be highly demotivating if executive directors are excessively remunerated. Therefore, these issues and perceptions need to be managed effectively in business organizations.

Table 10.2 - Examples of perceived equity and inequalities in the workplace

Examples of perceived equity	Examples of perceived inequities
Senior managers getting higher compensation packages because the value of their experience and skills (inputs) is greater.	A worker gets greater recognition and remuneration for his/her contributions, although other colleagues have done the same amount and quality of work.
More productive salespeople are paid more. The pay differential acts as an incentive to work harder.	A colleague getting more time than others to complete the same tasks. 'Favouritism' is deemed to be unjust and unfair.
Part-time workers, such as those in full-time education or mothers of very young children, earn lower monetary compensation than full-time staff.	Workers get a 5% pay rise due to record profits being earned, but a rival firm with similar financial results rewards its workers an 8% pay rise.
The captain or most valued player of a professional sports team gets paid more than other members of the team due to the skills and leadership qualities	Two similarly ranked managers have different sized offices, one with good ventilation, air conditioning and a nice view whilst the other does not.

Exam tip !

Equity (fairness) is not the same as equality (sameness). Achieving *equity* in the workplace means the organization is fair, attentive and appreciative. *Equality* would mean all workers being paid exactly the same, which might not be fair for a range of reasons.

ATL Activity 10.2 (Communication and Thinking skills)

Perceptions of equality in the workplace – With a partner, discuss the following questions and see if you are able to come to any sort of consensus?

- Is it fair that the average salary in the workplace is higher for men that for women?
- Is it fair that women can typically retire earlier than men, even though men in general have a shorter life span?
- Is it fairer for the boss to leave work before his/her employees?
- Is it fair to impose differentiated minimum wage rates that are dependent on a person's age rather than their skills, experience, or qualifications?
- Why don't some countries have anti-discrimination laws regarding a person's age, race, gender, sexual orientation, religion, national origin or physical (dis) ability?

Victor H. Vroom's **expectancy theory** (1964) suggested that people only put in the effort to do a task if they expect that their role will help to achieve the required result. If workers feel they lack the ability, expertise or skill to achieve a target or to complete a task, then their level of effort will be minimal (which reflects a lower level of motivation). Professor Vroom, of the Yale School of Management, showed that a variety of factors affect a person's approach and attitude to work. However, it is assumed that workers will choose the path that offers the greatest probability of achieving their goals.

Vroom found a positive correlation between a person's efforts and his or her level of performance at work. He recognized that a worker's performance is based on personal factors such as experience, skills, knowledge and self-belief. He suggested that when faced with alternative approaches to dealing with a certain task, people choose the option with the greatest motivation, consisting of three parts:

Motivation = Expectancy × Instrumentality × Valence

- *Expectancy* - This refers to the belief that effort will lead to acceptable performance. People have different expectations about their capability and self-belief in tackling a task or job. There are also different perceptions about the level of difficulty of the task.
- *Instrumentality* - This refers to the performance reward. People hold the perception that if they meet performance targets then they will be rewarded accordingly (or what they think is desirable as a reward). Managers must ensure that promises are kept in order to gain people's trust and therefore their commitment, loyalty and motivation.
- *Valence* - This is the value of the reward to the individual employee. Managers need to find out what staff value as people place different values on different rewards. In tackling a task, people consider whether it is worth any extra effort in terms of both intrinsic rewards (such as satisfaction and ego) and extrinsic rewards (such as money and promotion).

To determine the level of motivation, all three parts are weighted from 0 and 1 (with zero being the least significant and 1 being the highest) and then multiplying the three together (Expectancy × Instrumentality × Valence). The higher this number, the more likely employees are to be highly motivated. By contrast, the lower the number, the more likely employees are to be demotivated and dissatisfied at work.

Similar to equity theory, expectancy theory suggests that there is a correlation between the effort people put in at work and the expected rewards they achieve from that effort and the results obtained. Vroom argued that "*employees will be motivated if they believe their strong effort will lead to good performance that will lead to their desired results*."

A criticism of expectancy theory is that it does not provide any specific suggestions on how to motivate employees but provides a framework that highlights individual and cognitive differences in motivation.

HIGHER LEVEL

Exam tip !

The key difference between equity theory and expectancy theory is that:

- Equity theory suggests that people gain job satisfaction by comparing their effort (input) and reward (output) ratio with others. The employee is motivated if s/he feels the input to output ratio is fair in line with others in the organization or society.
- Expectancy theory assumes that people behave in a certain way in exchange for rewards based on their conscious expectations. The employee is motivated if s/he intrinsically perceives that the reward is adequate.

Case study 10.2 - Cristiano Ronaldo

In 2021, Cristiano Ronaldo (aged 36) became the world's most expensive football player having switched from Italian club Juventus to re-join English Premier League club Manchester United, where he previously played from 2003 to 2009. Ronaldo earned a reported $125 million for his services during the 2021-22 football season, of which $70 million was paid in salaries and a further $55 million from brand endorsements. This means that one day's work for Ronaldo equated to about 16 times the annual salary of the average person in Portugal!

In September 2021, Ronaldo set another record as the highest goal scorer of all time in international football when he scored for Portugal for the 110th time during the World Cup qualifying match against Ireland. Ronaldo is the first footballer to have earned over $1 billion in pre-tax earnings.

Only Cristiano Ronaldo himself truly knows the underlying motivating forces behind his move from Juventus to Manchester United.

Question 10.3 - Andy Hay Management School

Andy Hay Management School (AHMS) is a **non-government organization** that provides professional courses in Business Management. Andy Hay, the founding president of AHMS, is seeking to employ a new vice president and a senior marketing lecturer on a two-year renewable contract by mutual agreement and subject to satisfactory performance. As a prestigious management school, AHMS requires all applicants to have a minimum of four years full-time relevant managerial experience. The following information was collated for the advertised posts:

	Vice president	Senior marketing lecturer
Salary (annual)	$78,000	$45,000
Housing allowance	$10,000	$18,000
Gratuity*	22%	22%
Pension^	$1,250	$1,250

* Gratuity is paid as an end of contract bonus based on the percentage of the employee's annual salary.
^ AHMS employer's contribution towards each employee's pension fund.

(a) Define the term *non-government organization*. *[2 marks]*

(b) Using the information and data above and with reference to equity theory, evaluate the extent to which the remuneration package at AHMS might motivate its employees. *[10 marks]*

Table 10.3 - Summary of motivation theories

Theorist	Theory	Main findings
F.W. Taylor	Scientific management	Pay, above all, is the main source of motivation
A. Maslow	Hierarchy of needs	Levels of human needs, from physiological to self-actualization
F. Herzberg	Motivation-hygiene theory	Hygiene factors (which do not motivate alone but prevent dissatisfaction) and motivation factors
D. McClelland	Acquired needs theory	Managers have varying degrees of n-Ach, n-Pow and n-Aff
E. Deci & R. Ryan	Self-determination theory	Based on the basic and positive human tendency to grow: autonomy, competence and relatedness
J.S. Adams	Equity theory	Workers are motivated if there is perceived fairness based on an input to output ratio
V. Vroom	Expectancy theory	Motivation depends on expectations of effort needed and the perceived value of the rewards

Theory of Knowledge (TOK)

Given the motivation theories and theorists specified in the syllabus all have a North American bias, what do we really 'know' about motivation? Why is there no dominant motivation theory?

Labour turnover (HL only) (AO2, AO4)

Labour turnover measures the percentage of the workforce that leaves the organization in a given time period, usually one year. It is calculated by using the formula (for each time period):

$$\text{Labour turnover} = \frac{\text{Number of staff leaving}}{\text{Total number of staff}} \times 100$$

For example, if twelve teachers left during the academic year in an IB World School where 96 teachers are employed, the labour turnover rate would be 12.5%.

The main reasons why people leave their jobs can be summed up by internationally best-selling author M.J. Yate, who used the acronym CLAMPS as the six acceptable reasons for labour turnover: **C**hallenge, **L**ocation, **A**dvancement, **M**oney, **P**ride (or Prestige) and (Job) **S**ecurity. If staff leave because they are demotivated or disgruntled, this raises concern for managers and employers.

A low labour turnover rate suggests that the organization has recruited the right people for the job and that the existing employees are content and motivated at work. By contrast, a high labour turnover rate suggests that staff are incompetent or lack job satisfaction. It might also be due to better job opportunities and remuneration packages offered by other employers. In any case, a high labour turnover rate will clearly add to the costs of recruiting and training new staff in addition to the lost

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productivity when experienced staff leave. For example, ACAS estimates the average cost of replacing just one worker in the UK to exceed £30,000 ($42,000). A recent *Gallup* report in 2021 suggests that the cost of replacing an individual employee in the USA can range from 1.5 to two times the employee's annual salary.

Some organizations tend to have higher rates of labour turnover than others. Businesses that hire lots of part-time and temporary staff, such as McDonald's and Walmart, are likely to accept higher rates of labour turnover, mainly due to the nature of the job (such as the relatively low wages paid to low-skilled workers).

The opposite of labour turnover is **staff retention**. The benefits of high staff retention are the opposite of the drawbacks of high staff turnover. For example, consider if your IB Business Management teacher left the school at the end of your first year in the IB Diploma Programme. For students, there is a lack of continuity and a period of time to adjust to the new teacher in your second (final) year of the IB DP. For the school, there are the costs of recruitment to replace the current teacher. The successful recruit may need time to adjust to the school culture as well as having to undergo a period of on the job training to learn about the policies and processes at the school.

Firms with high staff retention tend to be those that motivate their workers and develop a positive organizational culture (see Chapter 11). They regularly offer staff training for both personal and professional development. There is effective leadership and workers are made to feel valued. All this helps to boost employee well-being as the staff see their employers valuing their contributions and professional development. Employers also benefit from the resulting increase in productivity and employee loyalty.



Figure 10.6 - Labour turnover can be highly expensive

Question 10.4 - Walmart

Walmart is the single largest private sector employer in the USA. The retail giant has a workforce of more than 1.5 million people in the USA (2.3 million worldwide), many of whom are hired on a part-time or temporary contract basis. Unlike most of its rivals in the US, such as Target and Costco, Walmart chose not to adopt a $15 starting hourly wage (sticking to $11 an hour) but focused instead on financial perks such as college tuition for $1 a day, a more generous parental-leave policy (including adoption) and a relaxed dress code (which enables workers to wear jeans, for example.

Walmart has faced many lawsuits and public relations issues regarding its treatment of workers, including concerns about low wages, poor working conditions, inadequate health care and the company's anti trade union policies. Reports have suggested that the labour turnover rate at Walmart is around 50%, with approximately 70% of the company's employees leaving within the first year. Despite this, Walmart say that the labour turnover rate is not a problem and in line with industry averages.

(a) Define the term *labour turnover.* *[2 marks]*

(b) Explain **two** reasons why a business such as Walmart might need to hire new workers. *[4 marks]*

(c) Explain the importance of understanding labour turnover for a large organization such as Walmart. *[4 marks]*

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Types of appraisal (HL only) (AO2)

The following types of appraisal: (i) formative, (ii) summative, (iii) 360-degree feedback and (iv) self-appraisal. AO2

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An **appraisal** is the formal assessment of an employee's performance in fulfilling his or her job based on the tasks and responsibilities set out in their job description. It is common for appraisals to be conducted on an annual or quarterly basis by a more senior member of staff, although interim meetings often take place between the appraiser and appraisee. Appraisals are part of an ongoing process that supports employees in order to enhance their performance at work. The advantages and disadvantages of appraisals are outlined in Table 10.4.

The appraisal system provides the opportunity for employees to engage in professional discussions with their manager(s). Communication is two-way, allowing workers to inform the employer about their concerns, training needs and professional aspirations. Managers provide constructive feedback to the employee in order to support their continuous professional reflections and development (see Box 10.3).

Box 10.3 - Common questions asked in appraisal meetings

Managers will use a range of data and information during appraisals meetings in order to assess each employee's performance. Some commonly asked questions include:

- What has gone well for you this year (what are your proudest moments)?
- What has not gone so well for you?
- What are you able to do now that you were not able to at the start of the year?
- What are the main areas for development?
- What can be done to help further improve your overall performance in the workplace?
- What training opportunities will help your professional development?
- Where do you see yourself in five years' time?

Table 10.4 - The advantages and disadvantages of appraisals

Advantages of appraisals	Disadvantages of appraisals
Appraisals are used to set targets, leading to positive changes and professional development of employees.	Appraisals are time consuming to conduct properly, so are costly. This needs to be budgeted for as an ongoing process.
They allow managers to objectively praise staff on their strengths and for their contributions in the workplace.	Confidential feedback must be given and follow-up action requires funding and monitoring if the process is purposeful.
Managers can use appraisals to provide constructive feedback to employees, which enables staff to focus on areas for improvement.	By their very nature, appraisals can be rather subjective as perceptions and relationships at work can interfere with the process.
Appraisals can be a useful way of getting valuable feedback from employees to help the organization adapt and improve.	Employees may get offended by some of the feedback comments, especially about their weaknesses or shortcomings.
Managers often aggregate the findings of appraisals to identify common strengths and areas in need of improvement. Thus, training and development needs can be better planned for the entire organization.	Many appraisers lack the skills, experience and confidence to carry out appraisals effectively. This diminishes the credibility of the process and the feedback or recommendations made.
Appraisals can be used as part of the process to determine levels of pay. This can be done by looking at the different tasks, responsibilities, skills, qualifications and challenges that a job entails. The appraisal process can then allow a business to objectively reward more demanding roles with higher rates of pay.	Employees can experience unnecessary anxiety and stress if the appraisal process is directly linked to pay. It can also be a time consuming and daunting experience for both the employee and the appraiser, especially with upwards appraisals (where a worker appraises the performance of his or her line manager).

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The HL syllabus specifies the following four types of appraisals: (i) formative, (ii) summative, (iii) 360-degree feedback and (iv) self-appraisal.

(i) Formative appraisal

Formative appraisal is the planned and ongoing process in which data and evidence are used to inform employees about what to do to improve their work practices. This type of appraisal enables managers and workers to engage in performance management conversations, encouraging employees to think about their own contributions to the organization. Formative assessment is commonly used in schools, such as teachers marking an end-of-topic test, grading it and adding written comments to inform students about how best to improve their performance.

Formative appraisal is often used for appraising workers hired for a probation (trial) period. For example, formative assessment is used to evaluate the competencies and performance of junior doctors, trainee teachers or novice supermarket workers during their apprenticeship or training period. The process helps the appraisee to modify his/her practices to improve their overall performance. Like most types of appraisals, the goals of formative appraisal include to:

- monitor the learning and performance of employees
- help employees identify their strengths and weaknesses (areas that need developing)
- help managers to recognise areas where staff are struggling so that any problems can be addressed promptly.

It does not really matter what specific methods are used in formative appraisal, so long as the information is helpful for employees to make any necessary adjustments to improve their overall performance. This might include methods such as observations of the worker, aptitude testing or a full diagnostic appraisal.

(ii) Summative appraisal

A **summative appraisal** is a written description of an employee's performance at work, summarizing what s/he has done and achieved during the year. The summative appraisal usually has recommendations for improvement (targets for a subsequent appraisal). It is used to hold staff accountable for their work, often testing the knowledge and competencies of employees.

For example, summative appraisals of teachers usually involve lesson observations carried out by senior managers, such as the school principal or one of the vice principals. They are similar to a summative report that students might get at school, often following a major assessment such as an end-of-year or mock examination. The feedback or review shows them what they have learned during the semester or the academic year, as well as targets for improvement.

The goal of summative appraisal is to evaluate the performance or contribution of workers by comparing this with a pre-determined standard or benchmark. Essentially, it is used to make a comprehensive and professional judgement of an employee's core competencies and to identify any specific areas in need of improvement.

(iii) 360-degree feedback

360-degree appraisal involves collecting evidence about the appraisee's job performance from a range of stakeholders who work with the employee. This might include his/her peers, subordinates, line managers or other parties (such as suppliers or customers) who have direct contact with the employee.

Opinions and feedback comments about the employee's performance are usually obtained by the use of questionnaires or interviews. The questions are focused on the core competencies of the appraisee, directly related to their job role.

This method is a popular method of appraising managers, with the aim of providing useful and pragmatic feedback to improve managerial performance and effectiveness. However, such appraisals often rely heavily on opinions rather than factual evidence. Hence, this method is not suitable for all businesses. It is also important for managers to consider group norms and sub-cultures before embarking with 360-degree appraisals. In some cultures, 360-degree appraisals are inappropriate as subordinates do not appraise their seniors.

(iv) Self-appraisal

Self-appraisal involves employees appraising themselves based on a set of pre-determined criteria. Appraisees are expected to be honest about their strengths and weaknesses. They also need to set realistic targets for improvement.

Some self-appraisal systems require workers to rate themselves. This is easier for some workers to do (the extroverts, for example) than it is for others who find it personally or culturally awkward to rate themselves. Quite often, the outcome of the self-appraisal

is compared to the assessment carried out by the line manager and then used as a basis for subsequent discussions. This can help to eliminate or limit potential bias from self-appraisals, especially if these are linked to pay and promotional prospects.

Irrespective of the type of appraisal used by an organization, if an employee falls short of the expected standards, the following actions can be taken:

- The employer issues an advisory letter to the employee (similar to issuing a warning letter).
- The worker receives advice on how to address his/her shortcomings (job performance), including recommendations of strategies for improvement.
- There is a dialogue about the consequences should there be no improvement in the worker's performance.
- There is closer monitoring and support of the appraisee, perhaps by calling for quarterly reports or more frequent updates.
- If no improvements are made within the agreed time period, action can be taken to dismiss the employee.

Business Management Toolkit

Discuss how descriptive statistics as part of the Business Management Toolkit (see Chapter 50) might be used to provide relevant information and data throughout the appraisal process.

Methods of recruitment (HL only) (AO2)

The recruitment of employees is critical to the running of an organization. They are hired to produce or provide goods and services. Hiring the right people helps to ensure that businesses can function effectively. As the recruitment process is likely to be time consuming and rather expensive, managers must ensure the methods of recruitment are appropriate and effective.

The recruitment process starts when a job becomes available within the organization, perhaps due to expansion of the business or to replace staff who have decided to leave the organization. People might leave a job for all sorts of reasons, such as to start a new job, to go into higher education, to spend more time with their children or because they were dismissed for misconduct.

Once the business has decided on the details of the vacant position, the job needs to be advertised. The various methods of recruitment with regards to job adverts include:

- Newspaper advertising - This is a common method as it has a wide audience. However, targeting the right people can be difficult and the advertising costs are high.
- Specialist trade publications - These are used to better target the right audience, such as management jobs in the UK supermarket trade being advertised in *The Grocer* (www.thegrocer.co.uk) or teaching jobs being published in the *Times Educational Supplement* (www.tes.com).
- Internet advertising - An increasing number of businesses are using the internet and social media platforms to advertise their jobs. They may use specialist recruitment websites (such as LinkedIn, SimplyHired, Job.com and Glassdoor) or their own company website to advertise job vacancies. Internet advertising can have a global reach yet only incurs relatively low costs.
- Commercial employment agencies - These agents advertise and interview suitable applicants for a job and make recommendations for selection to the hiring firm. Using employment agencies costs money (as they charge a fee for their services) but saves a huge amount of time for the hiring firm that might prefer to rely on the recruitment expertise of the employment agency.
- Job centres - These are non-profit organizations (see Chapter 2) funded by the government to help people find employment. Businesses can advertise their vacancies at job centres free of charge. However, job centres tend to be used for advertising relatively low paid jobs so this method might not be suitable for some businesses or jobs.
- University career fairs - Businesses may choose to go to specific universities to advertise their jobs. These jobs tend to be for junior management posts. University visits mean that there is a large pool of potentially suitable and talented people to choose from.

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- Employee referrals - This refers to personal recommendations made by a current employee who knows a suitable person with the necessary skills and qualities to fill a job vacancy. As is so often the case in the business world, sometimes it really is who you know rather than what you know that matters.

- Headhunting (or executive search) - This refers to the use of a specialized recruitment service that seeks out and recruits highly qualified candidates for senior-level positions, such as leading executive job roles. The hiring company needs to pay a premium for this service. The ideal candidate is sought for their experience, skills and knowledge. To entice them to leave their current employer, the hiring company will have to offer a contract, including a remuneration deal, that is simply too good to resist.

The various methods of recruitment with regards to the selection process include:

- Applicants for a job usually apply using a combination of three methods:
  - o *Application form* - a standardised document produced by the business for selecting appropriate job applicants. Employers can tailor questions on the form to meet their specific needs. Application forms make candidates answer the same questions in a consistent format, allowing the employer to compare like-with-like.
  - o *Curriculum vitae* - a document outlining an applicant's education, employment history, skills and professional qualifications. The curriculum vitae (CV), also known as a résumé, allows employers to see what the candidate has achieved and to judge whether the experiences and profile of the applicant meet their requirements.
  - o *Cover letter* - an introductory letter written by the applicant, stating which position is being applied for and why the applicant should be considered for the job. The cover letter (or letter of application) allows the HR manager to browse through potential applications, without having to first read all the CVs or application forms (many of which will be unsuitable).

- Interviews - This is the most common method of selecting the right candidate for a position. An interview is a two-way dialogue between the interviewer (representing the employer) and the interviewee (the candidate applying for a job) to help managers make an informed decision when selecting the best candidate for a job. Interviews provide the chance for an employer to meet with the applicant face to face, whether in person or via videoconferencing. Common interview questions can be found in Box 10.4. Interviews also allow applicants to get more information about the job and the organization in order to assess whether they would be happy to work there.



Figure 10.7 - Interviews are an important method used in the recruitment process

Box 10.4 - Ten common interview questions

1. Why do you want this job?
2. What do you know about this organization?
3. Why do you think that you will fit into this organization?
4. What are your key strengths?
5. What are your main weaknesses and what have you done about them?
6. Which leader/person do you admire most? Why?
7. Describe your key responsibilities in your last job.
8. Who was the most difficult person you had to work with and how did you manage this?
9. What are your key interests and how might these help you in this job?
10. Why did you leave your last job?

- Testing - Although testing can be time consuming, it increases the chances of hiring the best candidate for a job. By contrast, hiring the wrong applicant would increase costs in the future. The main types of testing used in this method of recruitment are:
  - *Psychometric tests* - these assess a candidate's personality and to gauge the attitude of applicants and their level of motivation. It is important to hire people who will fit into the culture of the organization, so many large firms use psychometric tests especially for more senior positions.
  - *Aptitude tests* - these examine the ability and skills of the applicants. For example, candidates for a secretarial job might be tested on the speed and accuracy of their typing and in-tray exercises to assess their ability to cope under pressure as well as their problem-solving skills.
  - *Intelligence tests* - these are used to measure the mental competence of an applicant, such as their skills of numeracy, literacy, reasoning and general knowledge.
  - *Trade tests* - these are used to examine a candidate's skills in a specific profession. Such tests are useful when standards or skills cannot be judged from an interview or from a candidate's application form. For example, voice tests are used when recruiting television newsreaders and radio presenters.
- References - These are written statements about an applicant from an independent source, usually the current or previous employer. Referees, the people who write employment references, may be asked to confirm the strengths and suitability of an applicant. They serve as a final safety check to ensure the information given by candidates in their application form, CV and job interview are accurate and truthful. Employers can then determine the suitability of the applicant for the advertised job.

Internal and external recruitment (HL only) (AO3)

Recruitment can be categorised as internal or external. **Internal recruitment** involves hiring people who already work for the business to fill a vacant post. This might happen when a business restructures its organization of human resources (see Chapter 8) or when internal candidates are successful in applying for promotional posts within the firm. Internal posts are usually advertised on staff notice boards, in newsletters or via staff emails. The advantages and disadvantages of using internal recruitment are outlined in Table 10.5.

Table 10.5 - The advantages and disadvantages of internal recruitment

Advantages of internal recruitment	Disadvantages of internal recruitment
Cost effective - It is usually cheaper and quicker to recruit from within an organization as suitable candidates may be readily available.	*Fewer applicants* - Internal recruitment limits the number of potential applicants yet external candidates could be better suited but are overlooked.
Less down-time - Internal candidates are already familiar with the culture of the business and how it operates. They are able to adapt and settle into the new post quickly. Hence, internal recruits can take up their new role with minimal down-time (the time needed to get familiar with the operations of the business rather than time actually spent on getting the work done).	*'Dead wood'* - Without external recruits, it might be difficult to get new ideas into the business. Firms lose out from having outdated working practises (known as dead wood) as staff have been there for too long. Quite often, managers discover that their staff lack the necessary skills and qualities to take up an internal promotion, so have to use external recruitment.
Less risk - Employing new workers from outside the organization could be risky in that their actual abilities and skills may not have been truly tested during the recruitment process. By contrast, recruiting internally might ensure that the job is filled with a more suitable candidate.	*Time consuming* - Redeploying, relocating, or promoting an internal candidate usually leads to another unfilled vacancy in the organization. Therefore, the process could be even more time consuming than if external recruitment had been used from the outset.
Motivational - Internal recruitment, especially for promotional posts, can act as a form of motivation. Providing internal candidates with opportunities for promotion suggests that managers value their employees. Hence, internal promotion can create employee loyalty and commitment to the business.	*Internal politics* - There could be resentment and conflict amongst fellow workers who were unsuccessful for the internal post. This can create an uncomfortable working environment for the people involved. Also, if no internal candidates are suitable then the business will still have to use external recruitment.

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External recruitment is the process of hiring people from outside the business. Methods used to recruit externally include the use of newspaper advertising, specialist trade publications, commercial employment agencies, job centres and headhunting - all of which were explained in the section above. An increasing number of organizations are also relying on social media platforms, such as LinkedIn (see Case study 10.3) for external recruitment purposes. The advantages and disadvantages of using external recruitment are outlined in Table 10.6.

Case study 10.3 - LinkedIn

LinkedIn is the world's largest social networking website for professionals. It launched in 2003 and had over 20 million users within its first three years and almost 260 million users within ten years and over 96,800 members joining each day during its first 15 years of operation! At the start of 2021, LinkedIn had over 740 million registered users in over 200 countries and territories. Employers can list jobs on the website and recruit top workers in a cost-effective way, whilst employees can look for jobs, make connections with other professionals and find business opportunities.

Table 10.6 - The advantages and disadvantages of external recruitment

Advantages of external recruitment	Disadvantages of external recruitment
'New blood' - People hired from outside the organization can bring in new ideas and creative ways of thinking. They can contribute to the sharing of best practise and give the business insight to how a rival business might have done things.	*Greater degree of uncertainty* - When hiring external recruits, managers take a risk as they do not really know the candidates or their ability to do the job effectively. Even if they are able, they might not fit into the corporate culture.
Wider range of experiences - Similarly, external recruits might be more qualified or more suitable than any of the internal candidates, perhaps because they have gained the experiences and skills required by the business during their time with their previous employer.	*Time consuming* - External recruitment takes longer than internal recruitment. Advertising, shortlisting, interviewing and checking references all take up valuable management time. Adhering to anti-discrimination employment laws further lengthens the process.
Larger pool of applicants - Businesses will have a wider range and larger number of candidates applying for the job. This increases their chance of finding the ideal person for the job.	*Expensive* - External recruitment can be very expensive, such as the costs of job adverts in newspapers. There is also the opportunity cost of management time during the recruitment process.

Question 10.5 - Pfizer

Pfizer is an American multinational pharmaceutical company. It employs around 78,500 people around the world. The company uses the motto CANI (Continuous and Never Ending Improvement) as a guiding principle for motivating the workforce. Pfizer uses both financial and non-financial methods to encourage employee loyalty. The company claims that 80% of management positions are filled using **internal recruitment**. The culture is one of encouragement and risk-taking rather than name and shame (blame).

(a) Define the term *internal recruitment*. *[2 marks]*

(b) Explain **two** likely benefits for Pfizer in using internal recruitment. *[4 marks]*

(c) Explain why a culture of risk-taking is important to pharmaceutical companies such as Pfizer. *[4 marks]*

(d) To what extent might managers over-estimate the importance of using financial rewards to motivate their employees? *[10 marks]*

Financial rewards (AO2)

The following types of financial rewards: (i) salary, (ii) wages (time and piece rates), (iii) commission, (iv) performance-related pay (PRP), (v) profit-related pay, (vi) employee share ownership schemes and (vii) fringe payments. AO2

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Financial rewards refer to the various methods that businesses use to motivate workers that involve some form of monetary payment. The main methods of financial rewards are considered below.

(i) Salary

Salaries are financial rewards set at a fixed annual rate but paid on a regular basis. For example, a person earning $36,000 per year is paid $3,000 per month or $1,500 fortnightly. Salaries can improve a firm's cash flow as workers are paid a fixed amount just once a month, usually directly into the employee's bank account. This is also safer and more convenient as there is no need to pay workers in cash.

Salaried workers often have to work more than their contracted hours but are unlikely to be paid for this extra work as any overtime is usually considered to be part of the job (just ask your teachers!) By contrast, those earning wages might be paid in cash on a more regular basis (usually weekly or even daily in some cases).

Salaries are often used in professions where output or productivity is not easy to measure and where linking pay with speed can lead to lower quality standards, such as in the case of teachers, psychiatrists and healthcare professionals. However, salaries suffer from two key limitations:

- As it is not easy to distinguish the efforts or output of different workers, it can be difficult to reward those who are more creative and productive.
- There is little, if any, incentive to work harder since people are paid the same amount for their time. This can encourage slack or procrastination in the workplace.

One way to deal with these problems is to introduce a formal appraisal system (see above).

Key concept

To what extent might fixed salary payments limit **creativity** in the workplace?

(ii) Wages (time and piece rates)

Wages are the reward for labour services usually expressed as an hourly rate (time) or as a measurable quantity of output (piece rate). Wages based on time can be paid per hour, per day or per week. Low-skilled workers in manual jobs tend to be paid by hourly rates. The wage rate is likely to depend on the worker's experience and scope of responsibilities.

In many countries, a **national minimum wage** is set by the government, so all employers must pay their workers no less than the stipulated rate. Wage earners are often paid an **overtime rate** for the hours they work over and above their contracted hours. It is common for the overtime rate to be paid at *time and a half* (50% extra pay per hour) or *double pay* (100% extra pay per hour) to compensate the employee for sacrificing more leisure time.



Figure 10.8 - The more hours an employee works, the more wages the worker receives

A key advantage of using wages is that it is a straightforward method which is easily understood by employees. However, the main disadvantage is that workers are not rewarded for their efforts but their time. This might encourage slack and poor productivity as well as hinder creativity and change.

Piece rate is a payment system that can get around the problem of time-based wages by rewarding more productive workers. Piece rate, advocated by F.W. Taylor, pays workers for each item that they produce or sell per time period. For instance, if a machinist in a clothing factory gets paid $1.50 per garment

and manages to produce 200 items of clothing in a week, then the gross earnings would be $300. This ensures that workers are paid for the amount of work they actually do rather than the time they are at work. For example, the more rides that taxi drivers complete, the more their remuneration becomes.

The key advantage of piece rate is that employees have an incentive to work hard to maximise their earnings. However, there might be a trade-off between the quantity and quality of output, so there tends to be a need for supervision and quality control. Staff might also be demoralised due to the uncertain level of income from piece rate, often caused by factors beyond their own control (such as mechanical failure or extreme bad weather) which would reduce their output and productivity, thereby negatively impacting their earnings.

Common mistake

Students often use the terms 'salaries' and 'wages' interchangeably. This is inappropriate as salaries are a fixed cost whereas wages are a variable cost (see Chapter 16). Instead, it might be better for you to use the terms '**earnings**' or '**remuneration'.**

ATL Activity 10.3 (Research and Thinking skills)

Go to the KPMG website (www.kpmg.com) or a similar website to investigate which countries charge the highest rates of income tax.

Perhaps more interestingly, find out which countries charge a zero rate of income tax? Discuss the reasons why a government might choose to impose no taxes on people's incomes?

(iii) Commission

Commission pays workers based on a proportion (percentage) of sales or output contributed by a worker. This contrasts with *piece rate* which is a fixed amount per unit made or sold. For example, real estate agents might get paid 1% (the commission) of the value of each property that they sell. So, an agent who sells a $500,000 property would earn $5,000 in commission. This payment system is commonly found in jobs where financial rewards act as an incentive to sell more. For example, insurance brokers receive a percentage of the premiums paid on policies that they have arranged.

In reality, it is common for people on piece rate or commission to receive a basic salary. To some extent, this helps to meet their physiological needs so even if the person does not manage to sell anything, s/he will still be paid the basic amount of pay. However, for each item sold, the salesperson will earn commission thereby boosting his/her overall earnings.

Exam tip !

In reality, the earnings of most employees are subject to personal income tax and other deductions. The total amount earned during a period of time is called the **gross earnings**. The government allows people to earn a certain amount of money (known as the **tax allowance**) before they pay income tax. The amount received after all deductions are paid is known as **net earnings**, i.e. the take-home pay. Whilst most jobs advertise the gross pay, it is the net pay that employees ultimately receive.

Question 10.6 - Calculating financial rewards



(a) Outline the meaning of a *time-based financial reward system*. *[2 marks]*

(b) Pravin earns $5 per hour as a part-time worker at a fast-food restaurant. His contracted hours are 12.5 hours per week. Calculate his weekly gross pay. *[2 marks]*

(c) Marj earns $2,400 per month. Income tax rate is 15% and her personal tax allowance is $18,000 per year. Use these figures to calculate Marj's:

(i) annual gross income *[2 marks]*
(ii) annual taxable income *[2 marks]*
(iii) annual take-home pay. *[2 marks]*

(d) Buki is a salaried teacher at a school, earning $3,400 per calendar month. Calculate how much she earns per week. *[2 marks]*

(e) As a salesperson, Phil earns a basic salary of $1,250 per month. Last month, he sold goods to the value of $12,000 for which he earns 5% commission. Calculate Phil's gross pay for the month. *[3 marks]*

Output-based reward systems such as commission can overcome the problems of time-based systems such as wages. However, they also have their own limitations:

- Speedy production or aggressive selling techniques do not necessarily correlate with high quality output or good customer service.
- There is added pressure on workers to sell more or to perform at a faster pace.
- Tasks can be quite repetitive and monotonous, thereby causing boredom and demotivation.
- There could be a need to hire more quality controllers, especially in manufacturing jobs.
- As commission depends on fluctuating sales or output levels, it is difficult to meet security needs because workers do not know how much they will be paid.

(iv) Performance-related pay (PRP)

Performance-related pay (PRP) rewards employees (as individuals, teams or as a whole workforce) who meet certain goals. These performance-related goals may be linked to sales targets, competence in a job or successful completion of a contract. PRP can be paid in various ways:

- *Pay rise* - an increase in a person's remuneration due to meeting or exceeding pre-determined and pre-agreed performance targets.
- *Performance bonus* - paid as a one-off reward to workers who have reached or exceeded output or quality targets. For example, salespeople might receive a cash bonus for reaching their monthly or annual sales targets.

- *Gratuity* - paid to staff who complete their employment contracts. For example, international schools often pay teachers hired from overseas a gratuity (an end-of-contract bonus based on a pre-set percentage of the employee's annual salary).

A key advantage of PRP is that it creates incentives for people to work and perform better, especially if targets are clearly set. PRP is also seen as a fair system because hard work is rewarded (see Adams's equity theory above). Furthermore, PRP helps to develop a performance culture where people strive to achieve their targets in return for benefits such as opportunities for promotion or a financial bonus.

However, PRP does suffer from several limitations such as the following points:

- Targets might be unrealistic or unachievable, so this can cause resentment and hinder job performance.
- The pressure imposed on workers to meet their targets can cause undue stress (especially if their pay is linked to achieving unrealistic performance targets).
- PRP is not appropriate for some professions where quality is more important than quantity, such as public sector doctors and teachers as it is difficult to quantify their level of output or performance.
- It might not encourage teamwork as individual targets are set in performance appraisal meetings (even though team targets can also be set). This can lead to workers feeling rather alienated and demoralized (see Deci and Ryan's self-determination theory above), especially if they feel their colleagues are being better rewarded (see Adams's equity theory above).
- Important aspects of non-financial motivators are ignored under a PRP reward system.

(v) Profit-related pay

As a form of financial motivation, **profit-related pay** involves linking remuneration to the level of profits in the organization, i.e. the greater the profits, the higher the pay. Profit-related pay is usually paid as an annual bonus. For example, Southwest Airlines paid its workers an extra 11.3% in 2018 (the equivalent of 5 weeks' extra pay) as part of its $543 million profit-sharing scheme with its employees. Some airline companies pay a thirteenth month bonus, paid along with the December salaries of employees. The amount paid will usually be linked to each employee's salary and the length of service, so those on higher salaries and who have been with the organization the longest are rewarded the most. This is seen to be a fairer way to share any profits with the workforce.

Profit-related pay is used to strengthen employee loyalty and to foster team spirit because profits can only be achieved by combined team efforts rather than by an individual's input. As American football coach Vince Lombardi (1913 - 1970) said, "*the achievements of an organization are the results of the combined effort of each individual.*" Hence, profit sharing should boost motivation and labour productivity as well as limit the possibility of potential conflict in the workplace. Another advantage is that it can help to break down a 'them and us' culture (see Chapter 11) as teams of managers and employees work together to achieve higher levels of profit.

However, the proportion of profits paid to employees is often seen as too small to provide any real and sustainable incentive to work any harder. Walmart, the world's largest retailer, announced in 2007 that it was to bring back annual bonuses paying an average of $651 to its 1.3 million hourly-paid workers (but the pay-out equated to under $1.80 per day for each worker!) Also, individual efforts are not explicitly recognised by this payment system, so there is no reason for any individual to improve their own performance. By contrast, performance-related pay (see above) is more flexible than profit-related pay as a reward system. In reality, profit sharing is often used to reward senior managers rather than for the entire workforce, especially as individuals lower down in the organizational hierarchy have no direct influence in changing the firm's overall level of profits.

(vi) Employee share ownership schemes

This payment system rewards workers, managers and directors by giving them shares in the company or by selling the shares at a discounted price. It is often used as an alternative to awarding a cash bonus or profit sharing. The motive for using employee share ownership schemes is that workers (who become shareholders of the company) will have a more direct interest in the well-being of the organization. Subsequently, employers gain from lower rates of staff absenteeism and labour turnover.

In reality, share ownership schemes tend to work better for more senior managers and directors in the organization. The majority of employees do not qualify for share ownership and even if they did the amount distributed is hardly enough to sustain their level of motivation and productivity. Hence, employee

share ownership schemes might prove to be impractical for most businesses.

(vi) Fringe payments

Fringe payments (also known as **financial perks**) are the monetary benefits to employees in addition to their wages or salaries. Examples include health insurance, housing allowance, employer's contributions to employee retirement funds, staff discounts, subsidised meals, gym membership, paid holidays and paid sick leave. Fringe benefits vary from one business to another and often depend on an employee's position or rank in the organization.



Figure 10.9 - Some businesses offer their employees free gym membership as a financial perk

Key advantages of using fringe payments are that they boost staff morale and encourage employee loyalty. They can also help to meet the safety and esteem needs of employees (see Maslow's hierarchy of needs theory) and make workers feel more valued as the extra benefits help to enhance their overall remuneration.

The main disadvantage of using fringe payments is the potentially high costs. For example, it is likely that all employees qualify to receive basic fringe benefits, such as annual paid leave (holiday pay), free uniforms, pension contributions and private medical cover. In addition, senior managers might qualify for further fringe benefits, such as company cars, housing allowance and business-class air travel. These business expenses can be an enormous burden on a firm's cash flow position (see Chapter 20).

Case study 10.4 - Google's fringe payments

Google offers its full-time US-based employees a $5,000 subsidy on the purchase of a Toyota Prius, Honda Civic Hybrid, or Honda Insight. Google's corporate image of innovation is coupled with its aim to preserve the environment by subsidising workers who buy environmentally friendly cars. Other fringe payments include free food (breakfast, lunch and dinner), a fully equipped gym, free laundry, electric scooters for on-site use and $12,000 per year for reimbursement of private tuition fees. If a Google employee dies, the spouse gets half of the salary for the next 10 years *and* the children get $1,000 a month until they turn 19!

Case study 10.5 - The world's top paid CEO

According to *Forbes*, Elon Musk (the CEO of Tesla and Space X) is the world's highest remunerated person having a reported total annual compensation of $6,658,803,818 in the 2020-2021 fiscal year (that's over $760,000 per hour!).

Question 10.7 - Perez International Consultants

Perez International Consultants (PIC) was set up in 1983 and is a highly successful private management consultancy firm based in Marbella, Spain. In addition to their salaries, consultants at PIC enjoy **fringe payments** such as housing allowance, profit-related pay and a company car.

Diana Perez, the new chief executive officer (CEO) who joined a year ago, has decided there needs to be some radical changes to ensure that PIC remains competitive. Annual pay increments would now be based on **performance-related pay**, based on a performance appraisal system carried out by line managers. Diana also stated that consultants would get a 5% pay cut, to bring salaries in line with industry norms. This would also allow the PIC to cut its fees by up to 3% within the next year in order to attract new corporate clients.

(a) (i) Define the term *fringe payments*. *[2 marks]*

(ii) Define the term *performance-related pay*. *[2 marks]*

(b) Using relevant motivation theory, examine the possible consequences of implementing Diana Perez's proposals at PIC. *[6 marks]*

(c) Evaluate the CEO's plan to remunerate management consultants by using performance-related pay. *[10 marks]*

CORE

Non-financial rewards (AO2)

The following types of non-financial rewards: (i) job enrichment, (ii) job rotation, (iii) job enlargement, (iv) empowerment, (v) purpose/ the opportunity to make a difference and (vi) teamwork. AO2

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Non-financial rewards are non-monetary factors that motivate people by offering psychological and intangible benefits, i.e. factors not directly linked to money. Most motivation theorists, including Deci and Ryan, McClelland, Maslow and Herzberg, advocate the use of non-financial methods of motivation. Examples of non-financial rewards are explained below.

(i) Job enrichment

Herzberg emphasised that making a job more interesting or challenging is a crucial motivating factor. **Job enrichment** (or **vertical loading**) gives workers more challenging jobs with more *responsibilities*. Hence, people have greater autonomy and authority in their work and have better opportunities to accomplish their jobs. It can also result in the psychological growth of employees, so they become more committed to their work. Furthermore, the ability to do a variety of tasks means that workers have a better sense of engagement and achievement.

A key limitation of job enrichment is the added expenses of time and money needed to train and develop workers to fulfil these extra roles and responsibilities. Another drawback is that job enlargement increases the workload of employees, which can cause anxiety, stress and hence lower productivity. Managers must also ensure that jobs are not too challenging or too complex for an employee who does not have the right skills set because this would lead to disastrous outcomes and can destroy the confidence and morale of the worker.

(ii) Job rotation

Job rotation is a type of non-financial reward that involves workers performing different tasks at the same level of complexity in a systematic way. This means that employees perform a number of different tasks in a particular order or sequence. For example, supermarket employees might work at the checkouts as cashiers one day, then rotate to work in other areas such as the delicatessen, bakery or stacking shelves on other days.

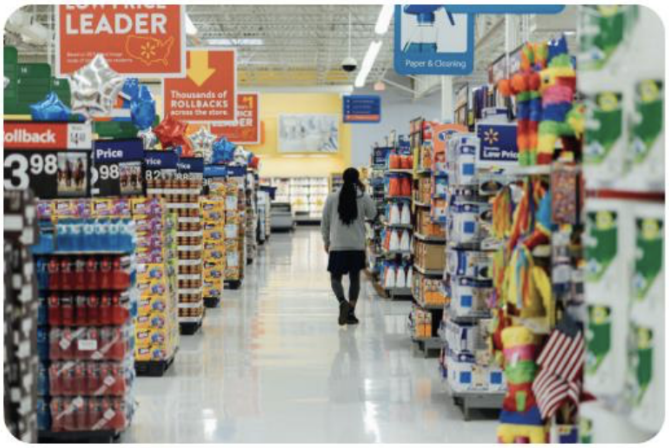

Figure 10.10 - Job rotation is commonly found in large supermarkets

The intention of job rotation is to provide more variety to avoid the problems of over-specialization (such as boredom caused by performing the same tasks repetitively). Job rotation also makes it easier for people to cover for absent colleagues as they become more familiar with a range of job roles. However, multiskilling requires greater costs of training and can be regarded by some employees as simply adding to their workload without any real career development opportunities.

(iii) Job enlargement

Job enlargement (also known as **horizontal loading**) refers to broadening the *number of tasks* that an employee performs, although the nature of the job itself remains essentially unchanged. For example, an administrative worker might spend most of the day looking after the reception area, dealing with customer enquiries, but also spend some time on data input, photocopying documents, filing and other clerical tasks.

One purpose (advantage) of job enlargement is that it reduces the monotony or repetitiveness of tasks that can cause boredom and demotivation. Job enlargement can make work more interesting as it involves employees having a wider range of tasks. However, some employees might view this as a way to get them to do more work for the same amount of pay, thus leading to demoralised and demotivated workers. In addition, any benefits of job enlargement are likely to diminish after a period of time if the roles become mundane (unexciting and unchallenging). Finally, the continual enlargement of a job over time can lead to unmanageable workloads for staff, thus causing demotivation.

Exam tip !

Be sure you know the difference between *job enrichment* and *job enlargement*. Job enrichment (vertical expansion of roles) is essentially dependent on job enlargement (horizontal expansion of job roles) whereas job enlargement can take place without job enrichment. Job enrichment is most helpful for employees who want to advance in their professional careers.

(iv) Empowerment

Empowerment is about developing the potential of workers or teams to achieve the best they can. It involves granting workers the *authority* to be in charge of their own jobs and to execute their own ideas to solve business problems. Hence, workers have some autonomy in decision-making so can decide for themselves the best way to deal with a task or issue. Empowerment can boost motivation as workers can take initiative and have a say in how things are done. Thus, they have a greater sense of pride in their work. For instance, in the education profession, the principal of a school usually allows subject teachers to plan and deliver lessons in a way that they see most appropriate for their students.

Empowerment requires giving workers the necessary authority, skills, resources and opportunities to achieve individual and organizational objectives (see Chapter 3). As Chinese philosopher Confucius (551 BC - 479 BC) said, "*I hear and I forget. I see and I remember. I do and I understand.*"

Empowerment can be achieved through various methods, including:

- *Delegation* - This occurs when managers pass on authority to their subordinates, allowing them to take charge of a particular job role and to gain recognition for his/her accomplishments. Delegation works best when subordinates have the competence (ability) and desire (willingness) to take on additional responsibilities. Managers must also ensure that staff are given sufficient time and resources to accomplish the delegated tasks. Successful delegation can therefore boost motivation and help employees to gain invaluable experiences to progress in their careers.

- *Worker participation* - This occurs when employees have opportunities to participate in decision-making, so they feel engaged and empowered, such as by using

employee suggestion schemes (see Question 10.2) or the use of quality circles (see Chapter 37) when dealing with a particular task or problem. Essentially, effective worker participation schemes allow people to become more involved (empowered) and interested (engaged) in their work.

- *Training and development* - Employers who provide opportunities for their staff to participate in continuing training and development tend to find that the costs of provision are far less than the benefits reaped from having a more loyal, empowered, productive and more motivated workforce. This is because employees feel more valued if the business provides them with authentic training and development opportunities. This can also help workers to progress in their professional careers.

However, empowerment must be used appropriately. Delegating tasks to empower staff can only be successful if the workers have adequate skills and have received the necessary training to independently deal with given tasks and roles. Managers are still held responsible for the tasks or projects they delegate, so inappropriate use of empowerment can lead to expensive mistakes being made.

CORE

Exam tip !

Delegation can empower a worker by giving to him/her the *authority* to take charge of a particular task or project. However, the *responsibility* of success or failure ultimately stays with the manager. In other words, authority can be delegated but responsibility cannot.

(iv) Purpose (the opportunity to make a difference)

Human resource management

Whilst some employees are driven by self-interest, others are motivated by using their work to help others thereby making a difference to the world we live in. Such employees are altruistic (selfless) and see the purpose of work being to make a positive change in other people's lives. Doctors, nurses, social care workers, firefighters and teachers are examples. History has shown that during times of crises, people cooperate to help each other.

Very importantly, *purpose* is about the role or job itself rather than acts of altruism such as donating money to an external charity (which only generates perceived impacts on beneficiaries). The motivation to make a difference occurs when people have the opportunity to build ongoing relationships with the beneficiaries. This is apparent with charity and social care workers who are fully committed to their work in making a difference to others.



Figure 10.11 - Some workers are motivated by being able to make a real difference

McKinsey & Company, the American global management consultancy firm, has shown through numerous studies that people with satisfactory salaries need more than financial rewards to sustain motivation. The studies showed some non-financial rewards are more effective than additional pay. The opportunity to help others or to make a difference to society can be motivational and give workers a real sense of purpose. Financial rewards such as bonuses or employee share options generate short-term gains in motivation but can have negative unintended consequences due to the expectation that these rewards become the norm. Philanthropy and alumni donations are common examples of how all employees can make a difference to others.

Case study 10.6 - The world's top philanthropists

The world's top philanthropists have given billions to help others. Bill Gates and Melinda Gates are well known as philanthropists, having donated a combined $74.6 billion primarily focussed on matters related to healthcare and poverty alleviation. Other top philanthropists include Warren Buffet ($34 bn), George Soros ($32 bn), Azim Premji ($21 bn) and Li Ka-shing ($10.7 bn). However, the top philanthropist of all time is Jamsetji Tata (founder of India's Tata Group) who is reported to have donated $102.4 bn (inflation-adjusted), mainly for education and healthcare

Source: http://www.therichest.com

(v) Teamwork

"*A boat doesn't go forward if each one is rowing their own way.*" - Swahili Proverb

Teamwork occurs when employees work with fellow colleagues. An example is teams that work together in their respective functional areas (see Chapter 1), such as departmental teams in finance, marketing and operations management. Another example is *quality circles* (see Chapter 37) which involves team members meeting regularly to discuss solutions to problems regarding quality within the production process.

Teamwork can help to meet the social needs of employees by building a sense of belonging. It can also help to reduce boredom (of working alone). Hence, this type of non-financial motivation can help to reduce absenteeism and labour turnover whilst boosting morale and productivity. It can also lead to greater flexibility and multi-skilling because employees learn from working with other team members. Hence, workers can cover for one another during times of absences without delaying the production process or reducing the quality of the service being delivered.

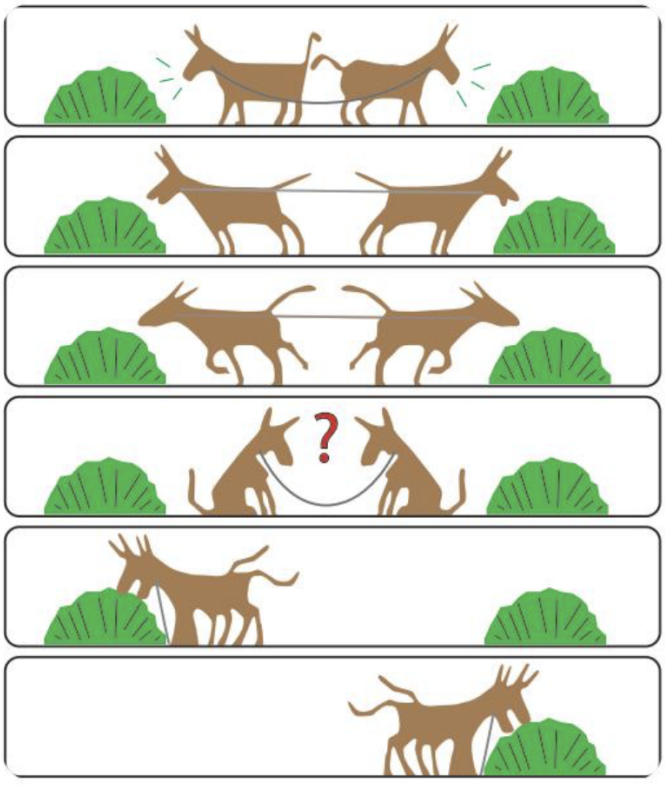

Figure 10.12 - Teamwork helps to solve problems more effectively

Business Management Toolkit

How does knowledge of Hofstede's cultural dimensions (see Chapter 54) help managers to gain a better understanding of what motivates different people?

ATL Activity 10.4 (Social and Communication skills)

In small groups, discuss the qualities needed to be a good team player. Given the benefits of group dynamics, what sorts of people would make an 'ideal' team?

Box 10.5 - Characteristics of successful motivators

The Institute of Management in the UK has observed three key characteristics of successful motivators:

1. **Positive thinkers** (the glass is half full, rather than half empty) - Having a positive attitude can go a long way in helping to achieve the strategic objectives of an organization.

2. They have and show **gratitude** and **appreciation** to their staff - This fosters harmony and trust in the workplace, thereby helping to bring out the best in employees.

3. They believe in the **self-worth** of all workers - It is human nature to yearn for acceptance and love (see Maslow's hierarchy of needs). When each employee's self-worth is boosted through motivation, the business is more likely to flourish.

Case study 10.7 - Financial vs non-financial rewards

Recent studies from global management consultancy firm McKinsey & Co. found that respondents view three non-financial rewards (praise from line managers, leadership attention to the work being done and a chance to lead projects) to be more effective in motivating and engaging workers than the three highest-rated financial rewards (cash bonuses, increased base pay and share options).

Exam tip !

As a critical thinker, remember that the financial and non-financial rewards in this syllabus do not apply to everyone or to every business. Some of these will work in some situations and not in others. The important exam skill is to apply the various financial and non-financial rewards sensibly and in a way that is aligned with the specific business in question.

CORE

Theory of Knowledge (TOK)

Is it possible to quantify motivation in the workplace in order to acquire knowledge of what actually motivates employees?

Human resource management

Common mistake

Many students seem to think that non-financial benefits do not cost a business any money. In reality, some types of non-financial rewards can be quite expensive, such as the provision of training and development opportunities for the workforce. Praise and recognition might not be as costly but will still take up management time if such practises are to be genuine and valued by workers.

Types of training (AO2)

The following types of training: (i) induction, (ii) on the job and (iii) off the job. AO2

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Training is the process of providing opportunities for workers to learn and acquire employment-related skills and knowledge. The amount and nature of training required will vary from one job to another. Some jobs require continual training or updating of skills and qualifications (such as those in working in legal and medical professions). Other jobs only require basic training to be carried out (such as low-skilled machine operators in a factory). Training is regarded as an important investment in what is perhaps an organization's most valuable asset.



Figure 10.13 - Training helps to develop a firm's human resources

The general **objectives of training** include:

- To enhance the efficiency and productivity of employees.
- To improve the quality of work of employees, including the quality of customer service.
- To develop a more multi-skilled, dynamic and creative workforce.
- To facilitate the personal and professional development of employees.
- To help employees adapt to change (including organizational, technological, social and legal changes).

The general and interrelated **benefits of training** include:

- It is easier and more likely to achieve business objectives (see Chapter 3) with a more skilled and flexible workforce.
- Improved competence leads to less *wastage* and *re-working* (having to do things again due to errors the first-time round).
- Greater efficiency and better productivity help to reduce costs.
- There is higher morale as workers feel self-assured, so make progress. This helps to reduce absenteeism and staff turnover because staff feel valued by employers who have invested in them. Workers also have improved opportunities for promotion as they become more skilled.
- As staff become more confident and competent in their job roles, the quality of output (including customer service) is likely to increase.
- Training helps employees to adjust better to changes in the internal and external environments. By updating their skills and being multi-skilled, employees are better able to cope with organizational change.
- By having a good reputation for training and developing staff, businesses might find it easier to attract high calibre workers.

The largest drawback of providing training opportunities is the financial costs. This includes the course fees for training as well as the loss of output whilst workers are being trained. For example, the costs of sending an IB teacher to a workshop held overseas include: air fares, taxi transfers, travel insurance, hotel accommodation, meal allowances, course fees paid to the IB and payment for a cover (substitute) teacher whilst the teacher attends the training (typically for three days). Another limitation is that effective training takes time to plan and this often consumes a large amount of a manager's valuable time. Furthermore, there is no guarantee that employees will stay at the business after being upskilled (gaining new skills, knowledge and qualifications through training).

Ultimately, the benefits of training mean that the workforce becomes more motivated, flexible and productive. If the benefits of training are greater than the costs, it is deemed to be financially justified.

The IB syllabus specifies three types of training: induction, on the job and off the job (see Figure 10.14).

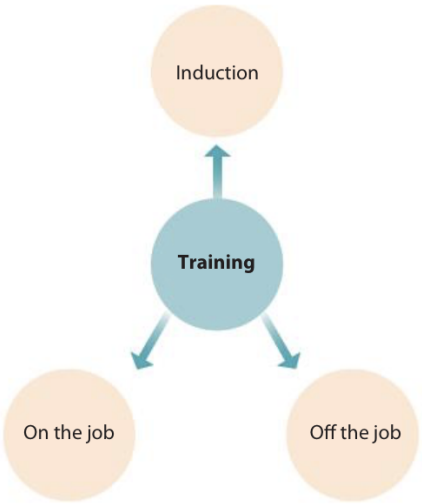

Figure 10.14 - Types of training

(i) Induction training

Induction training is a type of training aimed at introducing new employees to the organization. The purpose of induction training is to help new recruits to settle in quicker so they feel self-assured and supported in their new job. It can help to avoid costly mistakes being made by new employees who are not aware of the procedures or codes of behaviour required to carry out their duties. It can also help new recruits to integrate into the corporate culture of the organization (see Chapter 11).

Induction training might require a new recruit to:

- Meet key personnel, such as the employee's line manager and other members of their department or division.
- Learn about the new job role and other relevant duties and specific procedures.
- Tour the premises, including the recruit's main areas of work.
- Look at company policies and practices regarding matters such as hours of work, rest breaks, health and safety policies and fire or emergency evacuation procedures.

Table 10.7 - The advantages and disadvantages of induction training

Advantages of induction training	Disadvantages of induction training
Establishes clear expectations and good working habits from the start.	Planning, delivering and overseeing an induction course can be time consuming.
Helps new recruits to understand the *corporate culture* of the organization.	Trainers cannot carry out their other duties as they are involved in providing induction.
By settling in quicker, new recruits can contribute to the organization more promptly.	Information overload is counter-productive for new staff who have to absorb so much information.
Morale is boosted as new staff feel welcome and are more confident and competent in their job roles.	The length of induction programmes can be very long, especially in large and disparate organizations.

(ii) On the job training

On the job training refers to training carried out whilst at the workplace. For example, the training can be delivered by a manager, supervisor or other specialist. The trainees learn from the skilled colleague who delivers the training at the place of work. Essentially, this type of training involves 'learning by doing'. As Chinese philosopher Confucius said, "*I hear and I forget. I see and I remember. I do and I understand*".

Common examples of on the job training include:

- Demonstration – This involves an employee observing and learning about a specific task or process being carried out from an experienced member of staff. The trainer then supports the trainees who are given the opportunity to attempt these tasks and processes themselves.

- Shadowing – This refers to junior staff or new recruits observing and learning from more experienced and senior employees. This approach is commonly used for apprenticeship and internship schemes. The trainer allows the trainee to have a try at different aspects of the task, as well as provides suggestions and feedback to help the trainee to make progress.

- Mentoring – Mentoring is a hands-on training approach that promotes quick information transfer. Essentially, the mentor acts as a 'guide on the side', providing advice and pointing the person in the right direction in terms of career development opportunities. For example, a vice principal who aspires to become a head of school might shadow the principal who acts as a mentor in training and coaching the vice principal to prepare for principalship.

- Job rotation – This involves employees doing different jobs and learning the processes and procedures associated with these roles. This type of on the job training focuses on knowledge specific to the job and helps to promote cohesiveness in the workforce.

- Practice simulations – These are training opportunities that put employees in certain job-like scenarios. These simulations replicate the situations the employee is likely to face at work. For example, aircraft pilots spend hundreds of hours in practice simulations each year to ensure they are appropriately upskilled and able to cope with every foreseeable scenario.

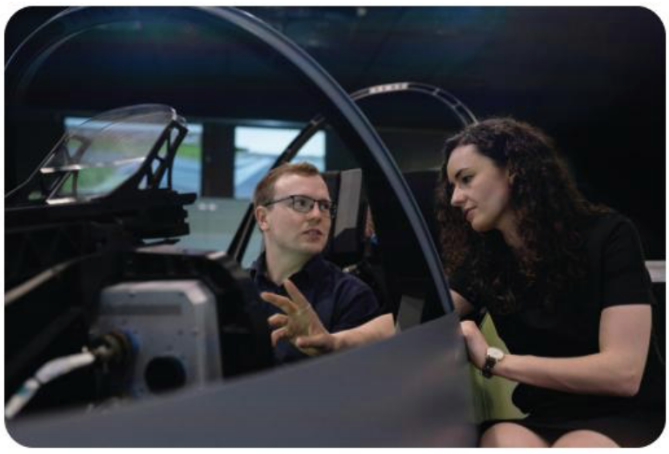

Figure 10.15 - Simulations are used in some professions for training purposes

Table 10.8 - The advantages and disadvantages of on the job training

Advantages of on the job training	Disadvantages of on the job training
Can be relatively cheap as the firm uses in-house specialists to run and facilitate the training.	Trainees may pick up bad working practices from the trainer (unnecessary short cuts and lazy habits).
Relevant as the training is targeted at issues directly related to the firm's needs.	Internal trainers may lack the most up-to-date training experience and skills.
Fewer disruptions to the firm's daily operations as the trainees are still 'at work' rather than being trained at a different venue and location.	Trainers will not be able to do their own work whilst facilitating the training. This means on the job training can be more expensive than expected.
Can help to develop professional relationships and collegiality at work as team working is involved.	On the job training is often rather piecemeal and incomplete due to a lack of resources.
The location is convenient for workers and trainers, rather than them having to go off-site, perhaps in a different city or country.	Labour productivity is initially lower as workers undergo the process of learning new skills and need time to develop these.

(iii) Off the job training

Off the job training refers to training conducted off-site, such as at a tertiary college or hotel conference centre. First-aid training, for example, might require specialist trainers and equipment that are not available in the organization. Teambuilding courses that help to develop problem-solving skills, for example, are also often conducted off-site. Although internal trainers can be used to lead the training, external specialists are usually hired for their particular expertise. For example, IB Workshop Leaders train and upskill teachers working in IB World Schools.

Off the job training may involve day-release for the training to take place. It is also common for employees to attend evening classes for some off the job training. It is common that key personnel, such as middle managers, are chosen to attend these training courses and are then expected to *cascade* (pass on) the skills and knowledge that they have acquired to the rest of their team members.



Figure 10.16 - Team-building opportunities can help to improve motivation

Case study 10.8 - IB training for teachers

The IB offers a range of off the job training courses for teachers in IB World Schools. These are offered as online virtual courses or face to face workshops, based on three different categories:

- Category 1 – staff training that focuses on IB philosophy and implementation, for schools and teachers new to the IB.
- Category 2 – training that focuses on the delivery of an IB programme for experienced teachers of the PYP, MYP, CP or DP.
- Category 3 – training focused on enhancing professional development portfolios in delivering an IB programme, such as Extended Essay workshops or upskilling training for the release of a new syllabus for a subject.

It is common for those who attend off the job training to provide the employer and service provider with official feedback. For example, a questionnaire can be used to assess the suitability of the course content and the extent to which participants feel the training course will help to improve their work. This can also help employers to determine whether the training could be extended to others in the organization.

Table 10.9 - The advantages and disadvantages of off the job training

Advantages of off the job training	Disadvantages of off the job training
Experts are used to provide the training, even if they might not exist or be available internally.	There is a potential loss of output (productivity) whilst workers attend an off-site training course.
A wide range of training courses can be provided, such first aid, ICT, customer relations management, health and safety, risk management or even foreign languages (for certain professions).	Hiring a suitable venue and specialist trainers can be very expensive. There may also be a need to reimburse staff for transportation and accommodation costs (for residential courses).
There are no distractions or disruptions from colleagues and customers as the training is usually conducted off-site.	It is debateable whether all the skills and knowledge learnt are relevant and therefore transferable to the organization.
Networking can take place, whereby employees get to meet other people who form the basis of business contacts.	Finding the time for staff to cascade the information and knowledge from the off-site training course can be difficult.
Morale is boosted as new staff feel welcome and are more confident and competent in their job roles.	The length of induction programmes can be very long, especially in large and disparate organizations.

CORE

Theory of Knowledge (TOK)

If employees are so diverse in their thinking, personalities and behaviour, what exactly is 'human nature'?

Human resource management

Question 10.8 - Northern Ireland's hotel industry

In a recent report on the recruitment situation in Northern Ireland's hotel industry, it was found that workers suffered from low wages (earning little much more than the national minimum wage), very limited career and promotion prospects and a lack of training and professional development opportunities. Professor Tom Baum and Frances Devine's report also showed that most hoteliers felt that **training** is a burden rather than a benefit, so should be kept at a minimum. Nevertheless, *The Irish Times* reported that more jobs were created in the hotel industry, with Dublin enjoying high hotel occupancy rates.

(a) Define the term *training*. *[2 marks]*

(b) Explain why "very limited career and promotion prospects" might create problems for hoteliers. *[4 marks]*

(c) Discuss the view that training is a burden rather than a benefit in Northern Ireland's hotel industry. *[10 marks]*

Motivation and the key concepts

One of the earliest recorded English proverbs is that "*You can take a horse to water, but you cannot force it to drink the water.*" This is because the horse will only drink if it is thirsty. Likewise, people will only perform their jobs well if they are motivated to do so. Furthermore, sustaining motivation in the workplace is hugely challenging. Productivity is dependent on an employee's level of ability and sustained motivation. The failure to motivate workers can lead to a range of problems, such as higher absenteeism, increased labour turnover, poor customer service and lower quality output. By contrast, a culture that fosters motivation leads to better labour retention and its associated benefits (see Box 10.6).

Box 10.6 - Benefits of higher staff retention

Retention is the opposite of labour turnover, i.e. it measures the proportion of the workforce that choose to remain working at the organization, rather than leave it. The benefits of staff retention include:

- Lower costs of recruitment, selection, induction and training of new staff.
- Improved corporate image, thereby making it easier to recruit new staff.
- Skills, knowledge and expertise are kept within the firm.
- A strong and unified corporate culture is established.
- Improved competitiveness and profitability, due to the above benefits.

However, there is no general strategy that best motivates all employees. This is largely because each and every individual worker is different. People are likely to be motivated by a combination of both intrinsic and extrinsic factors. *Intrinsic motivation* occurs when people engage in an activity out of their own desire, such as the enjoyment of pursuing a hobby or an interest because the person finds it to be challenging, stimulating or fun. Thus, intrinsically motivated students would want to master a subject rather than rote learn the subject simply to get good examination grades. Intrinsic motivation can also occur due to altruistic reasons, i.e. there is a sense of commitment to others. In many Asian cultures, intrinsic motivation occurs due to family reasons. For example, students seek to work hard partly due to family pressures and partly to avoid letting down their parents.

By contrast, *extrinsic motivation* occurs when people participate in an activity because of the benefits and rewards associated with doing so. These incentives might be tangible (such as wages, salaries and bonuses) or intangible (such as recognition and praise). Extrinsic motivation can also arise from organizational cultures that use pressure and threats, that is, workers engage in an activity to avoid punishments irrespective of whether this is deemed to be unethical. Some managers do not see any value in using non-financial motivators for workers who do not want responsibility or lack skills and ambition.

Change also has a major impact on motivation, productivity and job satisfaction. In reality, motivating the workforce is an extremely complex task because there are so many different factors to consider, each of which is subject to change. What motivates one person does not automatically motivate another. For example, the threat of redundancies for some people creates a sense of fear which might drive them to work harder in an attempt to secure their jobs. For others, the insecurity does not motivate but acts as a dissatisfier (refer to Maslow's safety needs).

Managers must therefore weigh up the costs of using various methods of motivation (such as profit-related pay) with the expected benefits (such as higher productivity).

Exam tip !

Motivation is not an isolated issue, nor is it a stand-alone topic within the syllabus. Instead, it is an integral part of the complex nature of strategically managing people within an organization.

Theory of Knowledge (TOK)

Given the complexities of human behaviours, can we ever truly know what motivates different employees?

Key concept

Is employee motivation driven by **ethics** or by the lack of ethics?

Key concept

With reference to an organization of your choice, discuss the impact of **change** and **ethics** on the level of employee motivation.

Key concept

Discuss the view that **ethical** organizations are more likely to recruit high-calibre workers and experience higher rates of employee retention.

REVIEW QUESTIONS

1. What is meant by motivation?
2. What are the benefits to a business in having a highly motivated workforce?
3. What are the signs of a demotivated workforce?
4. What were the main findings of F.W. Taylor's theory of scientific management?
5. What are the various levels in Maslow's hierarchy of needs?
6. How do motivation factors differ from hygiene factors in Herzberg's theory?
7. What are the three acquired needs in McClelland's theory? (HL only)
8. What is self-determination theory (Deci and Ryan)? (HL only)
9. How does equity theory differ from expectancy theory? (HL only)
10. What is meant by labour turnover? (HL only)
11. How is the labour turnover rate calculated? (HL only)
12. What are the four types of appraisal systems?
13. What are the main methods of recruitment? (HL only)
14. How does internal recruitment differ from external recruitment? (HL only)
15. How do financial rewards differ from non-financial rewards that are used to motivate employees?
16. How do wages differ from salaries?
17. What is the difference between job enlargement, job enrichment and job rotation?
18. What is induction training?
19. How does on the job training differ from off the job training?
20. How does intrinsic motivation differ from extrinsic motivation?



Figure 10.17 - Motivation is a highly complex issue in organizations

KEY TERMS

360-degree appraisal involves collecting evidence about the appraisee's job performance from a range of stakeholders who work with the employee.

Acquired needs theory, coined by D. McClelland, suggests that three types of needs must be satisfied to boost motivation: the need for achievement, power and affiliation.

An **appraisal** is the formal assessment of an employee's performance in fulfilling his or her job based on the tasks and responsibilities set out in their job description.

Commission is a type of financial reward that pays workers a certain percentage of the sale of each good or service that they are responsible for.

Differentiated piecework is an incentive scheme that rewards more productive workers who exceed a pre-determined benchmark.

Division of labour is the process of breaking down different aspects of a job or task and assigning different people to each particular part of the work in order to improve efficiency and output.

Empowerment is a non-financial motivator that involves developing the potential of workers or teams by granting them the authority to make decisions and to execute their own ideas to solve business problems.

Employee share ownership schemes are a type of payment system that rewards staff by giving them shares in the company or by selling the shares at a discounted price.

Equity theory is J.S. Adams' theory of motivation, which suggests that people make comparisons of perceived fairness in the workplace based on the ratio of their input (effort) to output (rewards).

Esteem needs in Maslow's hierarchy of needs refers to the desire of people to feel respected, having value and having self-respect.

Expectancy theory is V. Vroom's theory that assumes that people behave in a certain way in exchange for rewards based on their conscious expectations. He argued that people only put in the effort to do a job if they expect that their role will help to achieve the required result.

External recruitment is the process of hiring people from outside the business.

Formative appraisal is the planned and ongoing process in which data and evidence are used to inform employees about what to do to improve their work practices.

Fringe payments are the financial rewards paid in addition to a worker's wages or salaries, such as subsidised meals, housing allowance and pension fund contributions.

Herzberg's motivation-hygiene theory looked at factors that must be met in order to prevent dissatisfaction and the factors that actually motivate employees.

Hierarchy of needs refers to A. Maslow's theory of motivation, that people are motivated by different levels of needs: physiological, safety, social, esteem and self-actualization.

Hygiene factors are parts of a job that F. Herzberg referred to that do not increase job satisfaction but help to remove dissatisfaction, such as reasonable wages and working conditions.

Induction training is a type of training aimed at introducing new employees to the organization.

Internal recruitment involves hiring people who already work for the business to fill a vacant post.

Job enlargement refers to increasing the *number of tasks* that an employee performs, thereby reducing or eliminating the monotony of repetitive tasks.

Job enrichment involves giving workers more *responsibilities* and more *challenging jobs*.

Job rotation is a form of job enlargement whereby workers are given different tasks, but of the same level of complexity, to help reduce the problems associated with repetitive tasks.

Labour turnover measures the percentage of the workforce that leaves the organization in a given time period, usually one year.

Maslow's hierarchy of needs outlines five levels of needs, from satisfying physiological needs to self-actualization. Lower order needs must be met before people progress up the hierarchy.

Motivation refers to the desire, effort and passion to achieve something. It is the willingness to complete a task or job with intent and purpose.

Motivators are the factors that F. Herzberg considered to increase job satisfaction and motivation levels, such as praise and recognition.

Movement, according to F. Herzberg, occurs when people do something because they *need* to, so they feel obliged to do so.

A **national minimum wage** is the lowest hourly pay that all firms must remunerate their workers, as stipulated by the government.

Non-financial rewards are non-monetary factors that motivate people by offering psychological and intangible benefits, i.e. factors not directly linked to money.

Off the job training refers to training conducted off-site, such as at a tertiary college or hotel conference centre.

On the job training refers to training carried out whilst at the workplace. For example, the training can be delivered by a manager, supervisor or other specialist.

Performance-related pay (PRP) is a payment system that rewards people who meet set targets over a period of time. The targets can be on an individual, team or organizational basis.

Piece rate is a payment system that rewards people based on the amount that they produce or sell. Thus, their pay is directly linked to their level of productivity.

Physiological needs (or **basic needs**) in Maslow's hierarchy of needs are the requirements for human survival, including food, water, shelter and warmth.

Productivity measures the level of output per worker. It is an indicator of motivation as employees tend to be more productive with increased levels of motivation.

Profit-related pay is a type of financial reward system which remunerates workers a certain percentage or amount of the annual profits that the firm earns.

Purpose, as a non-financial reward, refers to the opportunity to make a difference.

Remuneration means the overall compensation package, such as salaries, commission, profit-related pay, performance-related pay, share ownership schemes and fringe benefits.

Safety needs (or **security needs**) in Maslow's hierarchy of needs are the requirements that make people feel safe, such as job security.

Salary is a type of financial payment that rewards workers a fixed annual amount of money, usually paid per month.

Scientific management, developed by F.W. Taylor, suggests that specialisation and division of labour help to increase the level of productivity. This is especially the case if pay is linked to a piece-rate reward system.

Self-actualization in Maslow's hierarchy of needs refers to the highest level of needs, which occurs when people become the very best that they can be and fulfil their potential.

Self-appraisal involves employees appraising themselves based on a set of pre-determined criteria.

Self-determination theory, coined by E. Deci and R. Ryan, describes three core requirements that facilitate growth and motivation in people: autonomy, competence and relatedness.

Social needs (or **love and belonging needs**) in Maslow's hierarchy of needs refers to the requirement to be accepted by others.

A **summative appraisal** is a written description of an employee's performance at work, summarizing what s/he has done and achieved during given period of time, usually a year.

Teamwork is a form of non-financial motivation, which involves the combined efforts of a group of workers to achieve organizational goals.

Time rate is a payment system that rewards staff for the time (rather than output) that they put into work. It is expressed per period of time, e.g. $10 per hour or $5,000 per month.

Training is the process of providing opportunities for workers to learn and acquire employment-related skills and knowledge.

Wages are a type of financial reward payment system based on time or output. Wages are paid as time rate (hours) or piece rate (output).

HIGHER LEVEL

Chapter 11

Unit 2.5 - Organizational (corporate) culture (HL only)

"A people without the knowledge of their past history, origin and culture is like a tree without roots."
- Marcus M. Garvey, (1887 - 1940), Jamaican entrepreneur and political leader

Contents

2.5 Organizational (corporate) culture (HL only)	
HL content	**Depth of teaching**
Organizational culture	AO1
Types of organizational culture (for example, Charles Handy's Gods of management)	AO2
Cultural clashes when organizations change including but not limited to when organizations grow and merge and when leadership styles change (HL only)	AO3

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Organizational culture (AO1)

Culture can be defined as the ideals, customs and routine social behaviours of a particular group of people or society in general. **Corporate culture** (or **organizational culture**) refers to the norms of an organization, such as the way that workers behave within the business, based on the beliefs, values and attitudes of the management and employees. It includes a range of dimensions such as the approach towards punctuality, dress code or whether informal communications are acceptable in the workplace. In essence, corporate culture represents the character or personality of an organization.

HSBC's global slogans "The World's Local Bank" and "Together We Thrive" highlight the importance of cultural awareness when doing business in overseas markets. As the popular proverb goes, "*When in Rome, do as the Romans do*", i.e. it is advisable for businesses to follow the cultural conventions of the local areas in which they operate.



Figure 11.1 - When working in another place, follow the customs of the local people

HIGHER LEVEL

Culture can help people to 'fit' in, based on the organization's history, traditions and customs. Understanding the culture of an organization is important to any manager who wishes to effectively implement change in the business. One of the most fundamental ways to establish a strong corporate culture is by using an agreed-upon and well-communicated mission statement (see Chapter 3).

A strong corporate culture exists when the employees are unified and understand, believe and support the vision and mission of the organization. By contrast, a culture gap exists if organizational values are not aligned. Subsequently, managers may need to exercise control by formal and perhaps bureaucratic procedures (see Chapter 8). Reasons for a business to establish a strong corporate culture include:

- Creating a sense of belonging and security for workers because they feel part of the organization. This helps to improve teamwork and to raise motivation in the organization (see Chapter 10).
- Promoting worker cohesiveness so that employees are driven (motivated) as they feel valued in what they have to contribute to the organization.
- Reducing mistakes and misunderstandings as workers are familiar with the processes and expectations at work.
- Minimizing problems associated with a weak corporate culture or an apparent culture gap so that conflicts (see Chapter 13) and misunderstandings between different stakeholder groups are curtailed.

ATL Activity 11.1 (Thinking and Communications skills)

Cultures in Songs - Decide on a list of 5 to 10 popular songs that represent you as an individual and your culture. Explain to a classmate why you chose these songs.

For example, you might choose "Under Pressure" by Queen because as an IB student, you constantly feel 'under pressure', or "Try" by P!nk as you feel you should always try your best and no matter how hard life gets you have to keep trying.

Human resource management

Types of organizational culture (AO2)

Types of organizational culture (for example, Charles Handy's Gods of management). AO2

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The acronym NORMS© can be used to remember the interrelated characteristics or determinants of different types of organizational culture:

- **N**ature of the business - Culture is shaped by the purpose and direction of the organization, derived from its mission and vision (see Chapter 3). For example, there is likely to be a very different culture in a non-profit organization (such as a charity or non-government organization) than one found in a business that thrives on aggressive selling (such as a real estate company).
- **O**rganizational structure - Firms with tall structures (see Chapter 8) tend to have lots of small teams that work well independently. By contrast, flatter structures may benefit from a culture of collaborative teamwork. Organizations made up of highly skilled and innovative staff have a different culture from those with demotivated staff who do not have any input in the decision-making process.
- **R**ewards - If employees are appropriately remunerated for their efforts, the organization is more likely to develop a strong and united culture. Hence, a motivated workforce results in a culture of driven workers who strive to achieve organizational objectives in productive ways.
- **M**anagement styles - The culture in decentralized organizations (see Chapter 8) tends to benefit from workers able to deal with most problems themselves, rather than taking all their problems to the management. Conversely, in organizations where managers maintain centralized decision-making power, a different culture exists with the use of threats and sanctions. In extreme versions of this type of culture, a significant amount of management time is spent on checking employee emails, monitoring their telephone calls or even using surveillance cameras to observe their workers.
- **S**anctions - An organization with few sanctions can lead workers to be slack (lazy or unproductive), to be late for work or even miss work and to provide poor customer service. However, if an organization is too rigid in its

policies and is extremely harsh in reprimanding workers, then employees may feel resentful of the management.

For example, each classroom has its own culture at least to some extent. The culture is largely influenced by the members of the group (the students) and the attitude and approach of the group leader (the teacher). Individual students might work better in some classes than in others because of the distinct group dynamics and different expectations of the teachers.

ATL Activity 11.2 (Thinking and Social skills)

Discuss with one or two other students how your classroom teacher (as an individual) influences the culture of learning for any one of your IB DP lessons. Also, consider how the students in the class (as collective individuals) affect the culture of learning in this subject. Finally, discuss how the cultural norms in your classes influence the individual members of the class. For example, you could discuss:

- Accepted behaviours, - the rules of the classroom, such as the use of language, expectations of conduct and the approach to homework deadlines.
- Classroom norms - what does "teaching and learning" look like in your classroom?
- Values - such as the perceived degree of inclusion, equal opportunities, support and collaboration.

What do these discussions tell you about the link between individuals and their impact on types of organizational culture?

In reality, organizations are vastly different in the ways that they operate. For example, the unique element of any organizational culture is its diversity. The various mix of ethnicity, languages, gender and social-economic groups within an organization means that individuals can shape the culture of the organization. This means there is no single dominant theory or type of organizational culture. Therefore, various types of organizational culture exist, most notably those suggested by Professor Charles Handy.

In his book, *The Gods of Management* (1978), Charles Handy argued that different cultures are needed for different businesses and their different activities. He stated that the culture used to run an efficient chocolate plant is different from that used to run a primary school or a construction site. Handy described four types of organizational culture in his model known as the **Gods of management:**

- **Zeus - Power cultures** exist when there is a dominant individual (such as the founder of the organization or a figurehead like Zeus) or group that holds decision-making power. For example, Steve Jobs, co-founder of Apple, led the company in a power-culture way. The organizational structure is likely to be flat with a relatively wide span of control (see Chapter 8). Formal job titles or positions may not be highly regarded because decision-making power is centralized, whereby senior directors keep hold of authority and control. Thus, decision-making is swift, especially as there is little bureaucracy involved. Evidence of power cultures come in various forms, such as reserved parking spaces and private toilets (washrooms) exclusively for senior directors of the organization.

- **Apollo - Role cultures** exist in highly structured organizations with formal rules, policies and procedures. Individual job roles are clearly stated in formal job descriptions and there is clear accountability. Power is devolved depending on the formal position an individual holds in the organization, with consideration of their skills, experience and qualifications. All individuals are accountable for something, so each employee takes ownership of the work that they are assigned. Role cultures are often found in schools and colleges.



Figure 11.2. - Handy used a temple to symbolise a role culture, for it is old, strong and well established

- **Athena - Task cultures** exist in organizations where the focus is on getting results from the work done. Unlike power cultures, there is no single source of decision-making power. Hence, teams are formed and empowered to achieve organizational goals and have some discretion over their responsibilities and autonomy to use their initiative to complete their work. Teamwork and cohesiveness are therefore vital in a task culture. Teams are comprised of individuals with common interests and similar or complementary specializations, who all have something to contribute. Unlike in role cultures, formal job titles are seen

HIGHER LEVEL

as less important than the contribution that team members make to completing tasks. Such cultures promote problem-solving through flexible and dynamic teams, often made up of representatives from different departments based on their expertise.

- **Dionysian - Person cultures** exist in organizations where a large number of employees feel that they are more important than the organization itself. Person cultures are common in professions such as accountants, consultants, surgeons and lawyers. Hence, a person culture consists of independent professionals within an organization, such as high-profile professional footballers or basketball players. It can also exist in retail industries where employees, especially part-time staff, turn up to work primarily for the money (pay) and do not get emotionally attached or develop any sense of loyalty to the organization. Essentially, person cultures only exist for the benefit of individuals, although organizations with such a culture can indirectly benefit from the creativity and drive of its employees.

Case study 11.1 - Charles Handy

Charles Handy is renowned for being one of Britain's greatest management gurus, having been credited in 2001 as the second most influential management thinker (after Peter F. Drucker). A graduate from Oxford University, Handy argued that trying to define a manager is less meaningful than examining what a manager actually does. Handy is widely recognised as Europe's best known and most influential social and management philosopher.

Key concept

In power cultures, the input of employees is not really valued, so it can be difficult for individuals to fulfil their motivational needs. Are there any **ethical** arguments in support of power cultures?

Question 11.1 - Warwick Park School

Warwick Park School (WPS) failed its latest school inspection. The government inspectors had commented that teachers and students at the school failed to engage in active teaching and learning. Examination results were very poor with only 25% of the students achieving the expected national standards. Although the inspectors noted that the school was a happy place, staff and students at WPS had grown accustomed to failure when it came to examinations.

Paramesh Murali, the new school principal, was hired to improve the quality of teaching and learning at WPS. He was known for his outstanding vision and entrepreneurial ability to turn around the fortunes of failing schools. At his first staff meeting, Paramesh Murali announced his radical plan for change, which included:

- Restructuring the senior leadership team.
- Introducing a system of monthly staff performance appraisals for the duration of the academic year ahead.
- Linking teachers' pay with performance management targets set by the principal.
- Lesson observations to be carried out on a random and unannounced basis.
- Changes to the school timetable to allow for more meetings, collaborative planning and extra-curricular activities.

Not surprisingly, the teachers at WPS were worried about job losses, the manner in which change was being imposed and the way that they were to be managed.

(a) With reference to WPS, outline the meaning of organizational culture. *[2 marks]*

(b) Explain why Paramesh Murali felt the need to change the organizational culture at WPS. *[4 marks]*

(c) Suggest how the concerns of teachers at WPS could be dealt with in order to foster the desired change in organizational culture. *[6 marks]*

Cultural clashes when organizations change (AO3)

Cultural clashes when organizations change, including but not limited to (i) when organizations grow and merge and (ii) when leadership styles change (HL only). AO3

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In reality, although one type of cultural dimension might dominate in a particular organization, country or region, there may be some groups that conform to other cultures or subcultures. These groups may have different opinions, values, beliefs and interests to the perceived cultural norms of the organization. This discrepancy among subgroups can cause a **culture gap** - the difference between the desired culture of a business and the culture(s) that actually exists.



Figure 11.3 - Values are the beliefs and moral stance of an organization

Culture clashes exist when there is conflict or incompatibility between two or more cultures within an organization. This can exist when firms grow organically, merge with other organizations, expands overseas or when there is a change in leadership.

Reasons for organizational cultural clashes

- Growth of firms - The internal growth of firms is likely to lead to a more formal and hierarchical organizational structure (see Chapter 8). This can result in organizations becoming more bureaucratic and power orientated in order to maintain control and coordination. In other organizations, an adaptive culture acts as the source of growth and evolution, rather than being the result of growth. Adaptive cultures exist in organizations that are responsive and receptive to change. Such organizations tend to be highly creative and embrace change. Culture clashes often also occur when businesses expand into overseas markets, especially if managers and workers are ignorant of differences in national cultures, for example.

Case study 11.2 - McDonald's Drive Thru

In 2005, McDonald's introduced the Drive-thru concept to China. However, this American cultural export was so abstract to Chinese drivers at the time that they actually bought food at the Drive-thru, parked their vehicles in the car park and then proceeded to eat their meals inside the McDonald's restaurants!

- Mergers and acquisitions (M&As) - Organizational cultures can clash or change when there is external growth, such as a merger with another company or an acquisition of another organization. In theory, M&As should help the organizations involved to gain from economies of scale (see Chapter 6). However, M&As can fail due to culture clashes. Even if the merger goes ahead, the culture of the more dominant company tends to prevail or a new hybrid culture develops. In reality, those who cannot adapt to the new culture are likely to leave the organization.

- Change in leadership - Leaders can have a huge influence on organizational culture (see Box 11.1). The qualities of effective leaders, such as their vision and interpersonal skills, influence the values and behaviours of the workforce thereby shaping the desired corporate culture. Leadership styles (see Chapter 10) are a key factor affecting corporate culture. Hence, a change in leadership can easily result in a change in the organizational culture. For example, consider how your school principal shapes the culture of the school and what might happen if s/he resigned. Leaders drive the strategic direction of the organization, so a change in the leadership team can result in culture clashes (see Question 11.2).

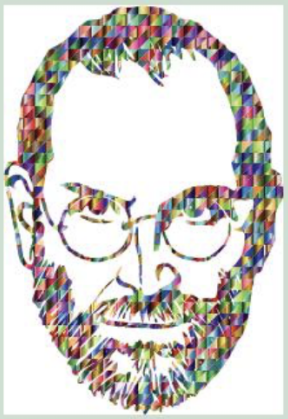
HIGHER LEVEL

Box 11.1 MOVER Leadership

A challenge for leaders is to influence people within their organizations to follow a shared vision and corporate culture. Strategies to achieve this include being a MOVER:

- **M**entor - Leaders act as mentors (see Chapter 7) by sharing their knowledge and expertise and supporting their teams to mould a healthy organizational culture. This also helps to build trust within the organization.
- **O**utreach - Communicating the vision and desired culture to all members of the organization, so everyone moves in the same direction and holds the same values.
- **V**ision - Without knowing where the business wants to be, it is impossible and pointless trying to guide and motivate staff.
- **E**ngaging - The desired corporate culture must engage and excite the workforce, perhaps by the leader nurturing a sense of self-worth and commitment to the goals of the organization. Empowering others (see Chapter 10) also means a greater number of individuals can help to shape the desired organizational culture.
- **R**ole modelling - As Mahatma Gandhi (1869 - 1948) said, *"You must be the change you wish to see in the world"*, i.e. effective leaders lead by example. By being a role model to others in the organization, the leader can drive and develop the desired corporate culture.

Case study 11.3 - Steve Jobs



Following his death in October 2011, aged just 56, Steve Jobs was acknowledged by political and business leaders as an iconic entrepreneur who helped to transform the daily habits of millions of people across the globe. Steve Jobs, co-founder of Apple, is remembered for being the visionary who reinvented computing, music and smartphones during what he called the 'post-PC era', changing the way we do things at home, school, work and leisure.

Theory of Knowledge (TOK)

As our own experiences and cultural backgrounds play a vital part in how and what we understand, is it possible to have objective knowledge across different cultures?

It is important to be aware of culture clashes due to the potential problems these can create. These consequences include:

- *Misunderstandings and miscommunications* - Cultural clashes and culture gaps often result in problems due to employees not understanding the reasons for change (see Chapter 7) or if these have not been communicated effectively with the workers.
- *Unhappy staff* - Cultural clashes and the potential conflict that results will tend to make people unhappy in the workplace, which is detrimental to morale and productivity.
- *Compromises must be reached* - In order for the business to move forward, conflict needs to be resolved. Compromises may therefore need to be made in the negotiation process (see Chapter 12).
- *Resistance to change* - This happens because staff are likely to resent changes to the culture that they are used to, perhaps due to fear of the unknown or due to a lack of understanding of the benefits of change. This can intensify conflict within the workplace (see Chapter 7).
- *Higher costs of implementing change* - For example, training costs may be necessary to align culture gaps in the organization.
- *National culture clashes / disputes* - National cultures may be so strong that any attempts to change the way things are done can cause conflict and resentment. For example, cosmetics firms may find it difficult to expand into countries where attitudes towards female liberation and freedom of expression are still rather conservative.

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Question 11.2 - Organizational culture at Lenovo

Founded in 1984, Lenovo is the world's largest computer maker. In 2005, the Chinese computer giant acquired America's IBM's personal computer division for $1.25 billion. Workers at the Lenovo plant in China are used to stringent manufacturing systems, with only 18 seconds to add components before they are moved on in the assembly line. This ensures more than 400 laptops are produced every hour. Workers are expected to show respect to their seniors (higher ranked staff). Unlike workers in the US, Lenovo's staff are not generally encouraged to voice their opinions or to question the decisions of their managers. Hence, any **acquisition** with overseas companies often proves difficult due to international **cultural clashes.**

(a) Define the term *acquisition*. *[2 marks]*

(b) In the context of the case study, outline the meaning of cultural clashes. *[2 marks]*

(c) Examine the problems that Lenovo might have faced trying to integrate two different corporate cultures. *[6 marks]*

Case study 11.4 - Disneyland Paris



'Euro Disney' opened in Paris, France in April 1992. The management was faced with staff protests after having insisted on English being the language of communication at its meetings. They had also enforced a strict dress code, based on American practices. Analysts blamed the huge losses made by the theme park in 1994 on this major culture clash. Disney's management subsequently adopted French working practices whilst keeping the core product 'American'.

In October 1994, the theme park was renamed 'Disneyland Paris'. Today, about 15 million people visit Disneyland Paris each year, making it the most popular theme park in Europe.

Business Management Toolkit

How do national cultures affect corporate cultures? Is there a strong relationship between the two in your country? You may find it useful to review Chapter 54 before attempting to answer this question.

Case study 11.5 - GM

In December 2013, US car giant General Motors (GM) announced Mary Barra had been internally promoted to Chief Executive Officer. Barra became the first female CEO of the company, having joined the company as an engineering student in 1980. The aftermath of the global financial crisis caused the US government to spend $49.5bn bailing out GM, taking a 61% stake in the company. A week after Barra's promotion, the US government had sold all its shares in GM.

HIGHER LEVEL

Question 11.4 The Body Shop

The Body Shop was founded by Dame Anita Roddick in 1976. The British company prides itself on being 'green' and socially responsible. Today, the company has operations in more than 3,000 retail stores in over 65 countries, serving almost 80 million customers each year. The Body Shop has five core values that are instilled in everything the company does:

- Against animal testing
- Support local community trade
- Activate self-esteem
- Defend human rights
- Protect the planet.

In 2006, The Body Shop was acquired by French cosmetics company L'Oréal for £652 million ($913m). In 2017, L'Oréal sold The Body Shop to Brazilian cosmetics company Natura & Co. for a sum of €1 billion ($1.14bn).

Logo and information reproduced with the kind permission of The Body Shop International plc.

(a) Describe the corporate culture at The Body Shop. *[4 marks]*

(b) Examine how ethical business behaviour can shape corporate culture **and** provide The Body Shop with a competitive advantage. *[6 marks]*

Exam tip !

To gain a greater understanding of the impacts of cultural clashes and strategies to tackle conflicts in the workplace, you should review Chapter 13 (Industrial/ employee relations).

Organizational culture and the key concepts

Understanding organizational culture is important for the effective management of any organization. **Cultural intelligence** or **cultural quotient** (CQ), is the ability of an individual to blend into occupational, corporate and national cultures. CQ is an indicator of a worker's ability to cope with change. The term was coined by Professor Christopher Earley and Professor Elaine Mosakowski in the *Harvard Business Review* (2004). Cultural quotient is important, especially during times of change, as it measures the ability of people to understand and adjust to unfamiliar situations such as a hostile takeover (see Unit 1.6) or a crisis (see Unit 5.7).

Organizational cultures change, develop and strengthen over time. Beliefs, norms, attitudes and values are more likely to be shared within the organization if they are given the time to do so. This makes any attempt to change the organizational culture a more challenging task. Nevertheless, as markets become more competitive and globalized organizations are forced into being more adaptive to change, creativity and innovation. In addition, political, economic, social, technological and legal changes (see Chapter 46) may require organizational cultures to adapt and embrace changes in the external business environment. For example, the outbreak of the COVID-19 pandemic caused huge changes to working practices as many people switched to working from home and relied on Internet technologies and videoconferencing platforms such as Zoom, Skype, Google Meet and Microsoft Teams to conduct their work.



Figure 11.4 - The COVID-19 pandemic changed how many people work

HIGHER LEVEL

Theory of Knowledge (TOK)

Have Internet technologies disrupted indigenous cultures?

ATL Activity 11.3 (Thinking and Communication skills)

As a class, describe the organizational culture at your school by using Answer Garden (http://answergarden.ch/). You can type words up to 20 characters for each answer. Reflect on the extent to which the results align with your school's mission statement.

Organizational culture impacts on the attitude of workers towards change. If employees are not interested in pursuing change, this could harm the business's ability to achieve its goals and to operate in a sustainable manner. A weak, negative and undesirable culture can lead to increased absenteeism, lateness and conflict, thereby intensifying costs for the business. By contrast, a strong culture of acceptance to change and embracing creative solutions to solving business issues will support an organization in responding to the changing needs of the market. Cultural harmony within an organization can only come about if all staff understand and share the same values. Without a shared vision, culture gaps and conflict can cause major problems for the organization.

Key concept

With reference to an organization of your choice, discuss how **ethics** influences its organizational (corporate) culture.

Key concept

Discuss whether a culture of embracing **change** is always beneficial to organizations.

Finally, it is important to recognize that it might not be possible or realistic to have just one culture within an organization, especially in large multinational companies where sub-cultures may exist. Today, societies face greater influences from other cultures, especially with the cultural diversity of people in many organizations. Competitiveness is therefore centred on being able to work effectively with those who may hold different values and beliefs. An understanding and appreciation of different cultures is essential for any effective and sustainable business strategy. After all, there is no right or 'best' culture for all organizations, especially as businesses are constantly exposed to the forces of change. An awareness of the differences in sub-cultures that exist within an organization can empower leaders to lead their organizations more effectively.

Theory of Knowledge (TOK)

Given that different cultural perspectives exist, are there any justifications for universal standards of ethical business behaviour?

Theory of Knowledge (TOK)

What does an understanding of culture enable us to know about Business Management as an academic discipline?

Business Management Toolkit

Read more about culture from international perspectives, or dimensions, by referring to Hofstede's cultural dimension as part of the Business Management Toolkit (see Chapter 54).

HIGHER LEVEL

REVIEW QUESTIONS

1. What is meant by organizational culture?
2. What are the main elements (or determinants) of organizational culture? (hint: NORMS)
3. Why is it important to understand organizational culture?
4. What is meant by Charles Handy's "Gods of management"?
5. What are power cultures?
6. What are role cultures?
7. What are task cultures?
8. What are person cultures?
9. What are cultural clashes?
10. What is a culture gap?
11. What are the main reasons for organizational cultural clashes?
12. What potential problems arise from cultural clashes?
13. Why is cultural intelligence important for managers?
14. How might a change in leaders or leadership styles influence organizational culture?
15. Why might cultural clashes occur as a business grows?

KEY TERMS

Adaptive cultures exist in organizations that are responsive and receptive to change. Such organizations tend to be creative and embrace change.

Corporate culture (or **organizational culture**) describes the traditions and norms within a business. It is largely based on people's beliefs, values and attitudes in the workplace.

Cultural intelligence or **cultural quotient** (CQ), measures the ability of an individual to blend into occupational, organizational and national cultures. It is an indicator of a worker's ability to cope with change.

Culture refers to the ideals, customs and routine social behaviours of a particular group of people or society in general.

Culture clash exists when there is conflict or incompatibility between two or more cultures within an organization, such as when two firms merge or when there is a change in leadership.

Culture gap refers to the difference between the existing culture of an organization and its desired culture. Management strives to reduce this gap.

Gods of management is the name of Charles Handy's theory or model of the four different types of organizational culture, namely power, task, role and person cultures.

Person cultures exist in organizations when staff feel that they are more important than the organization itself.

Power cultures exist when there is one dominant individual or group that holds centralized decision-making power.

Role cultures exist in highly structured firms with formal rules, policies and procedures. Individual job roles are clearly stated in job descriptions and power is devolved to middle managers.

Task cultures exist in organizations where the focus is on getting results. Teams are empowered and have some discretion regarding how they complete their work.

Values are the organization's beliefs and moral stance, which form an essential part of its organizational culture.

Chapter 12
Unit 2.6 - Communication

"The single biggest problem in communication is the illusion that it has taken place."
- George Bernard Shaw (1856 - 1950), Irish playwright and recipient of the Nobel Prize in Literature (1925)

Contents

2.6 Communication	
SL/HL content	**Depth of teaching**
Formal and informal methods of communication for an organization in a given situation	AO2
Barriers to communication	AO2

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Communication

Formal and informal methods of communication for an organization in a given situation. AO3

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Communication is the transfer of information from one party to another. Managers spend a significant part of their time communicating with both internal and external stakeholders. The purposes or objectives of communication include to instruct, clarify, interpret, notify, warn, receive feedback, review and, above all, to inform.



Figure 12.1 - Communications are vital to the success of any organization

Effective communication is vital to the success of any business so that staff are aware of their roles and the expectations of them and so that managers can gather and act upon feedback from employees, customers and other stakeholders. In other words, effective communication enables people to have a better understanding and control of what they do.

The term **channel of communication** refers to the method(s) through which communication takes place. For example, large retail businesses that want to announce an end of season sales promotion might choose to use television and/or newspaper advertising.

Communication can be categorized as internal or external. **Internal communication** refers to communication within the business organization, such as the store manager of a local McDonald's liaising with Head Office about a forthcoming promotional campaign. External communication is conducted between members of one organization and members of another, such as the store manager of a McDonald's restaurant contacting suppliers regarding different orders.

Formal and informal communication

Communication can also be classified as formal or informal. **Formal communication** refers to all official channels of communication. It is directly related to work matters, such as a discussion about who is the best candidate for a job vacancy or simply instructions or information being passed down from managers to their subordinates. Formal communication can be further categorized as **open channels** (used when information is not confidential and can be shared by anyone in an official capacity) or **restricted channels** (used when formal information is confidential and is directed only at those who need to know). The subsequent section in this chapter covers the various methods of formal communication for an organization.

Informal communication (or **grapevine communication**) refers to all unofficial, natural and unstructured communication channels that exist among informal groups within an organization, such as people from different departments talking about work- and non-work-related matters during their lunch break together. Such communications are free from organizational formalities. Informal groups tend to occur naturally because members share common interests, not because they are formally part of the organization. There are numerous methods of informal communication and as technology improves these are increasing further. It can be spoken, written or even conveyed through body language and physical gestures. Other examples of informal communication include:

- Catching up with colleagues, even if they do not work in the same division or functional areas.
- Casual conversations with work colleagues, be it the canteen, a corridor or at a social event after work. Informal conversations are an essential part of all businesses.
- Instant messaging platforms such as WhatsApp, WeChat and Facebook Messenger and other apps such as Instagram. These informal channels of communication are particularly popular with younger employees.
- Telephone calls that are not scheduled and without a pre-agreed agenda can often help to clarify matters in a faster and more effective way than using work emails, for example.
- Gossip and rumours in the workplace (something shared or heard but cannot be confirmed to be a fact). Gossiping exists in every business, especially in larger organizations with many workers across many departments.

Some managers see informal communication, especially gossip and rumours, as a hindrance to efficiency and productivity. In particular, informal group norms might not support the objectives held by management. In the worst-case scenario, informal communication can be damaging to a business especially if the wrong message gets leaked out to external parties such as competitors or the mass media.

However, other managers see informal communications in a more positive manner, suggesting that there are numerous benefits:

- Informal communication can foster a sense of belonging in the workplace. People from different departments can talk about non-work issues over lunch breaks or at social gatherings, for example. This can help to meet their social needs at work, as well as improving morale and motivation in the workplace (see Chapter 10).
- It can also foster a sense of security and mutual support. People can talk to colleagues who are regarded as friends in addition to being a work colleague perhaps to get messages clarified or to deal with any concerns or anxieties that they might have.
- The pooling of ideas of people across the organization can help to generate solutions that might not have emerged through more formal communication channels. People are also more likely to be open and creative during informal discussions. Formality itself can constrain what people say or do in a meeting, for example.
- Without informal communication, the workplace would feel too rigid and unfriendly. Informal channels of communication, such as social interactions, help to foster improved professional relationships, create a greater sense of belonging and help to distribute information more easily and effectively. It can also help management to receive more honest feedback and suggestions.



Figure 12.2 - Informal communications can help to improve staff morale

Effectively communication requires getting the right balance between internal, external, formal and informal channels, as well as knowing which to method(s) to use in different types of situations.

Exam tip!

Whilst informal communication does not necessarily relate directly to work matters, such engagements can improve communications throughout the business as well as foster social relationships in the workplace.

Theory of Knowledge (TOK)

Discuss the extent to which social media has distorted the divide between formal and informal communication and hence the interpretation of knowledge.

Theory of Knowledge (TOK)

How can we know just when too much informal communication in the workplace becomes detrimental to the organization?

Key concept

To what extent does formal communication restrict **creativity** in the workplace?

Methods of communication for an organization

Methods of formal communication for an organization include: (i) verbal, (ii) written, (iii) visual and (iv) non-visual channels of communication.

(i) Verbal communication

Verbal communication (or **oral communication**) refers to communication via the use of spoken words. It involves people talking and listening to one another, such as meetings, interviews and appraisals. It is quick because the sender and receiver are usually in direct contact with each other. Oral communication allows questions to be asked and for feedback and clarification to be given. However, whether a message is communicated well verbally depends on the skills of the speaker, such as the use of jargon or the tone of voice.

Examples of verbal communication include:

- Giving instructions or information, such as directors announcing and explaining a major change in the organization.
- Discussing problems in formal business meetings. Formal meetings are scheduled with a pre-set agenda (see Figure 12.3) that is communicated to relevant people prior to the meeting. Each agenda item will be discussed in turn with time scheduled for 'any other business' (AOB) at the end. A record of the meeting (called the **minutes**) is documented and shared with relevant people, which can be used for future reference.
- Job interviews for the recruitment and selection of staff.
- Job appraisals (see Chapter 7) as part of the organization's performance review process.
- Verbal presentations, such as at staff meetings, sales pitches, product launch events and at press conferences.
- People simply having conversations with each other in formal and informal settings.

Figure 12.3 - Example of an agenda for a formal meeting

Agenda for IB Business Management Staff Meeting	
Date:	24th January
Time:	3:30 PM – 5:00 PM
Venue:	Room 232
1.	Apologies for absences
2.	Minutes of last meeting – any matters arising?
3.	Mock examinations
4.	Internal Assessment update
5.	Extended Essay titles
6.	Upcoming IB 5-Year Review discussions
7.	A.O.B.

Advantages of verbal communication

- There is very little, if any, cost involved.
- Detailed questions can be asked.
- Questions can be answered without much delay, so feedback is quick and spontaneous.
- Interviews and presentations help to determine an employee's ability to communicate.
- Facial reactions and body language, along with the tone of voice, can often be judged.

Disadvantages of verbal communication

- For most methods of oral communication, there is not a permanent record of the conversation for future reference. Hollywood popularised the saying that "*A verbal contract isn't worth the paper it's written on*".
- The information given might not always be complete or truthful or it might be misinterpreted.
- Confidential messages can be difficult to communicate verbally, especially when many people are involved.
- Meetings and interviews can be very time consuming.

(ii) Written communication

Written communication refers to communication methods that make use of the written word, such as letters, memoranda, reports, notices, executive summaries, abstracts and research proposals. These forms of written communication provide a permanent record of the documented messages for future reference.



Figure 12.4 - Written communications enable records to be kept for future reference

a) Letters

Business **letters** follow a set format with important emphasis placed on the layout and formal language used. For example, letters should:

- indicate the name and address of the sender
- include the date
- have a reference (a focal point or a reference number)
- include proper salutations: 'Dear Sir/Madam…. Yours faithfully' or 'Dear Ms. Ducie… Yours sincerely'

Letters can be used for external communication (such as responding in writing to a customer enquiry or complaint) and internal communication (such as for passing on confidential information to an employee). Letters provide a hard copy that can be kept for future reference. They are also specific and can address issues in great detail. However, letters can be time consuming to produce and it might take a while to get a response from the receiver.



Figure 12.5 - Letters are prone to delays in the post

b) Memorandum

A **memorandum** (or **memo** for short) is a business note from one person to another. It can be a formal typed note or simply a hand-written message. Memos are used for internal purposes, such as when managers wish to call a meeting (see Figure 12.6), to send a reminder or when people want to pass on a quick message.

Memorandum	
To:	All Heads of Department
From:	Scott Kwiecien (Chief Finance Officer)
Date:	5th October
Re:	Dear all, Just a quick reminder that our rescheduled meeting will take place tomorrow at 1:30 PM in the Conference Room. Thanks, Scott

Figure 12.6 - Example of a memorandum

A memorandum can be very quick to produce. Also, as the message is short and specific, it should be easy to understand. They are not usually intended or useful for long messages or for passing on complicated information.

c) Reports

Reports are a formal method of written communication whereby information about something that has been researched or investigated is presented. Business reports follow a specific format and will tend to have:

- A title (cover) page with information such as the name of the author of the report, the audience it is targeted at and the date of the report.
- An executive summary of what the report is about and the purpose of the research or investigation.
- A contents page with page numbering.
- An introduction to the report.
- Section headings to separate parts of the report, especially if it is a long document.
- Conclusions and recommendations, where appropriate.
- A bibliography listing all sources of reference.
- An appendix with supplementary evidence, such as quantitative research data.

Business reports are prepared in detail for a specified audience and this makes communication direct and easier to understand. However, it can take a long time to investigate and produce written reports, by which time any findings or recommendations made might be outdated.

d) Notices

Notices are used when a message needs to reach a range of people, perhaps by postings on staff notice boards or on a company website as well as notices for customers. Notices can be formal, such as highlighting training opportunities or fire evacuation procedures. They can also be informal to the business, such as sponsorship notices for a charity event. Notices are often communicated on notice boards (or display boards) in the workplace.

Notices are useful for passing on messages so that everyone can see. They can contain a lot of important information that can be left as a reminder to staff. However, notices are not confidential and messages are often ignored, especially if they are outdated or there are too many notices cluttered together.

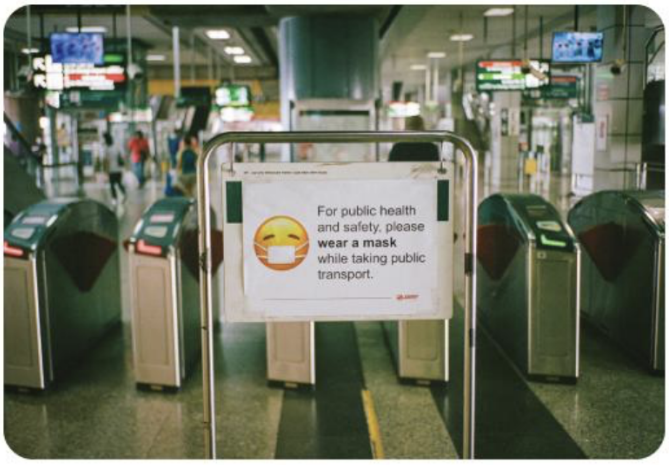

Figure 12.7 - Notices are used to communicate important messages

e) Executive summaries

The astonishing increase in the amount of information available online about almost every topic has generated growth in the number and scope of written communications, such as reports. Like all summaries, **executive summaries** are written to provide a condensed version of the contents in a report. Executives and directors do not have the time to read so many reports but still need easy and fast access to information, so this is where executive summaries prove their use. A typical executive summary follows the format below:

1. Scope and purpose of report
2. Methodology
3. Main results and findings
4. Conclusions and recommendations.

An executive summary provides the main findings in a report and often come with recommendations. The reader of an executive summary is a decision-maker who might have to decide on a course of action related to the contents in the report. Hence, all executive summaries must be written with this need in mind. They must be accurate as they are stand-alone documents so managers might make decisions based on the contents of the executive summary without necessarily reading the entirety of the original report.

f) Abstract

An **abstract** (also known as a **précis** or **synopsis**) is written as a condensed (shortened) version of a report without losing the original message of the report. It differs slightly from an executive summary in that an abstract does not directly provide any recommendations to aid decision making. An executive summary not only provides a summary of a report, but also the main findings and recommendations. In essence, a manager could do without reading the entire report if there is a succinct executive summary. This is not possible with an abstract alone as it does not include an evaluation of the main report. Abstracts also tend to be shorter than executive summaries.

g) Research proposals

A **research proposal** is a management planning document. It sets out the key issue(s) to be investigated. The research proposal may contain details of primary and secondary methods of research, an action plan with key dates and identification of any foreseeable problems (anticipated difficulties) likely to be encountered during the investigation process.

A major disadvantage of all written forms of communication is the issue of storage. Despite the use of ICT and cloud computing, businesses today use more paper than ever before. Managers need to be disciplined in this aspect - how long should businesses hold written records for? In addition, many types of written communication are slow and if the receiver does not understand the written message, there will be further delays.

(iii) Visual communication

Visual communication is the use of visual stimuli to communicate information or ideas. It is said that a picture paints a thousand words (Napoleon Bonaparte) and that images speak louder than words. Hence, visual aids can be used to enhance communication because they:

- Can be understood relatively easily
- Can communicate ideas quicker than words
- Are often cheaper to produce than pages full of words
- Cater for visual learners (some people understand messages better through the use of images than through verbal or written communications)

- May have a longer lasting impact, which is why marketers often use powerful images in their promotional campaigns (see Chapter 29).

Different visuals are used for different purposes. For example:

- *Bar chart* - for showing frequencies and for ease of comparing data sets.
- *Pie chart* - for expressing percentage figures, such as market share.
- *Infographics* - to show information using a combination of information (texts) and graphics (images).
- *Line graph* - to show time-series data, such as sales figures during the past twelve months.
- *Histogram* - useful for showing historical data and trends, such as sales over few years.
- *Video* - the use of moving images to communicate a message.



Figure 12.8 - Visuals can be used to enhance communications

Other examples of visual aids include photographs, symbols, tables, maps, sketches and diagrams. Examples from the Business Management Toolkit include:

- The Boston Consulting Group (BCG) matrix (see Chapter 47)
- Decision trees (see Chapter 49)
- Gantt charts (see Chapter 52)
- Forcefield analysis (see Chapter 55)
- Critical path analysis (see Chapter 56) and
- Simple linear regression (see Chapter 58).

Other forms of visual communication include sign language and body language. Sign language is used for those with hearing or oral difficulties. Body language can reveal a lot about a message. For example, is the recipient staring into the sky or maintaining good eye contact during an important conversation? Whichever image is chosen, it is important to remember *why* the method is being used and what purpose it serves.

Business Management Toolkit

Examine how elements of a business plan (see Chapter 48) can be used to communicate the aspirations of an organization.

(iv) Non-verbal communication

Except for oral communication, all forms of communication can come under the category of **non-verbal communication**. This refers to any form of communication other than oral communication, such as electronic systems (such as email), written methods (such as letters) and visual stimulus (such as body language). Examples of ICT-based non-verbal communication methods are outlined below.

a) Electronic mail (e-mail)

Electronic mail refers to the process of using computer wide area networks (WAN) as a mailing system. Data is electronically transmitted from one computer to another. It is a very fast method of communication because all the data (text, graphs, charts and images) are already in electronic form. Data can also be transmitted to many different recipients at the same time, all across the world. This helps the business to save on telephone bills and stationery costs.

However, the set-up costs can be quite high such as the purchase of computer hardware and equipment. There is also the on-going cost of using an internet service provider to provide broadband and Wi-Fi services. Moreover, data transmission via email is not always secure as it can be hacked into. This is one reason why many people still shy away from e-commerce and using credit cards for online shopping. Finally, computer systems and networks can go wrong (or 'crash'), subsequently causing communication failure.

Question 12.1 - Email usage at work

Research has shown that most **electronic mail** is accessed at work. However, many of the emails sent are personal messages, such as arranging social gatherings, rather than work-related issues. Research has also suggested that email usage in the workplace varies from country to country. For countries where email communication is widely used, the result has been an increase in the number of people who use the Internet to communicate with their colleagues. Some argue that using email in the workplace can improve overall efficiency whilst others believe that it is open to abuse and an excuse to avoid talking to people.

(a) Describe what is meant by *electronic mail.* *[2 marks]*

(b) Outline how email might encourage informal communication in the workplace. *[2 marks]*

(c) Explain whether you think that the use of email improves the efficiency of communication in the workplace. *[6 marks]*

b) Video conferencing

Videoconferencing (or video teleconferencing) uses a combination of telephone, computer and video technologies. It allows meetings to take place when staff are in different locations, thereby cutting out travel time and costs. The technology facilitates verbal and non-verbal forms of communication (such as body language). Videoconferencing allows people to see and talk to each other (using a webcam). Videoconferencing software can also enable users to record the conversations using audio-visual technologies. Examples include Skype, FaceTime, Teams and Zoom. More and more multinational corporations (see Chapter 6) are using this method for interviewing overseas candidates, for example.



Figure 12.9 - Videoconferencing has created many opportunities for business communications

Once the initial start-up costs have been paid for, videoconferencing has the advantage of being much quicker and cheaper than bringing people together in one location. An added advantage over ordinary face-to-face meetings is that video recordings can be made for future reference. However, a major disadvantage is that videoconferencing systems can be expensive. Meetings can also be more difficult to conduct due to the over-reliance on technology, such as Wi-Fi connectivity. Being virtual, meetings involving many people from numerous locations may have a slightly different 'feel' and lack the social aspects of face-to-face meetings.

c) Mobile devices

The traditional telephone is still immensely popular as a means of communication in the business world. However, smartphones and other mobile devices, such as tablet computers, have taken over in terms of popularity and ownership. The top four mobile phone producers surpassed one billion units for the first time in 2007. By 2021, there were 5.22 billion smartphone users around the world - around 66% of the world's population. The average person in Finland owns more than 2 mobile phones, whilst people in Japan replace their smartphones every nine months, on average.

Mobile devices are used by managers and employees who are increasingly 'on the go', such as real estate agents, sales representatives, insurance brokers and teleworkers (see Chapter 7). Technological progress, such as improved camera technologies and improve Wi-Fi coverage, has also further popularised the use of mobile devices as a form of information communication technology. As with videoconferences, the use of mobile devices facilitates both verbal and non-verbal forms

of communication (such as instant text messages sent using smartphone apps).

In summary, electronic methods of communications have a growing importance in the global business world. ICT has allowed for faster yet cheaper communications over long distances. However, this can mean the need to purchase and maintain expensive software and computer hardware. Whilst email can be cost effective, the use of smartphones for international calls can still be rather expensive. Businesses that rely heavily on ICT find that things tend to come to a standstill when computers and electronic equipment fail, perhaps due to technical problems or power outages.

Theory of Knowledge (TOK)

Management guru Peter F. Drucker said that *"the most important thing in communication is to hear what isn't being said". How can we know what we do not hear?*

In reality, businesses will use a mix of communication methods to fit their individual requirements and different situations. The type of communication method chosen depends upon a combination of the factors outlined below.

- *Personal preferences* - Some people may prefer to hold conversations with others about problems or issues, whereas other people may prefer to put their thoughts in writing.
- *Organizational structures* - A tall organizational structure, with many hierarchical structures, (see Chapter 8) requires more formal and sophisticated methods of communication.
- *Security issues and concerns* - For example, hard copies of important documents are often kept in case computer files get damaged or corrupted by a virus or hardware malfunction.
- *Skills and training of the users* - Many schools, for example, use a range of ICT to enhance teaching and learning, including remote and distance learning. However, unless the teachers have received proper training to use the equipment and software, such investments can be a waste of money as they are not fully utilised.
- *Ease of use* - Some people may prefer to use a sketch as part of their presentation rather than using technical software such as PowerPoint or Prezi. Sending out flyers to customers might be easier for many people rather than setting up their own website to convey the same marketing message.
- *Size of business* - Large firms with multiple locations might rely on emails to serve their communication needs, whereas a small business might prefer to mainly use verbal methods of communication.

Question 12.2 - The importance of non-verbal communication

The key factor to good communication is to pay attention to what others have to say. Good communicators are not those who simply speak at others. In the business world, effective communication is all about establishing a good rapport with customers, colleagues and suppliers. Not listening to customers can be a costly mistake - dissatisfied customers mean a loss of sales and less loyalty to the organization. Negative messages can be spread by customers very quickly via social media platforms. Most experts feel that effective communications management involves listening to what employees have to say and having genuine consideration for their needs.

In addition to listening skills, good communicators also show positive body language, such as a warm smile and making eye contact when speaking to someone. Research has shown communication is 7% dependent on spoken words, 38% on the tone of the voice, whilst the remaining 55% is on non-verbal signals.

(a) Outline **two** benefits of good communication to businesses. *[4 marks]*

(b) Examine the importance of non-verbal communication for marketing a firm's products. *[6 marks]*

- *Storage needs* - All orders placed by customers and business transactions need to be recorded, whereas an informal conversation about organizing a staff social event does not need any formal documentation.

- *Locations of sender and receiver* - Time zone differences in Australia and France, for example, may mean that an email is preferred to a telephone call or instant messaging.

- *Urgency* - Security and speed can mean a firm prefers to use a courier service provider, such as FedEx or DHL, instead of the normal postal system.

- *Cost* - The use of written communication tends to be cheaper than methods that rely on sophisticated ICT systems. Also, parcels sent by sea are cheaper than those sent as air freight but take longer to get to the recipient.



Figure 12.10 - Effective methods of communication can give businesses a competitive edge

CORE

Overall, businesses will look at the overall value for money in their choice of communication methods. For example, emails might be more cost effective for most external communications for a large multinational company rather than the use of telephones or videoconferencing. In any case, effective methods of communication can give businesses a competitive advantage over their rivals in the industry.

Human resource management

Barriers to communication (AO2)

Irish playwright George Bernard Shaw (1856 - 1950) said that "*The problem with communication is the illusion that is has occurred.*" In the business world, the term noise is used to refer to any barrier to effective communication. **Barriers to communication** refer to anything that can limit or impede the effectiveness of communications. Communication can fail due to any combination of the following reasons:

- *High costs* - Not all firms have sufficient sources of finance to set up good communication networks and to train all employees to become effective communicators.

- *Technological breakdowns* - For example, computer failures, viruses and crashes can disrupt, distort or delay communication messages.

- *Jargon* - This refers to technical language used in different professions. It is used to speed up and enhance communications. However, this can also cause communication problems when jargon is used to communicate with non-specialists. For example, end of semester reports written by teachers might contain a lot of subject-specific vocabulary that mean very little to some parents. Hence, problems arise when managers fail to identify situations when the use of jargon is inappropriate.

- *The fear of technology* - Technophobia refers to a fear of or having a negative attitude towards, the use of ICT. This can therefore prevent people from effectively using ICT for communication purposes.

- *Geographical location and distance* - Physical distances can mean that remote areas have limited communication access, such as mobile and telephone reception. There tends to be a positive correlation between distance and the cost of communication. Hence, geographical distance between the sender and receiver can be another barrier to effective communication.

- *Internal politics* - This occurs when there is conflict within an organization (see Chapter 13). This can generate rumours and gossip within the workplace and create a general resistance to cooperate with colleagues and/or management.

- *Poor presentation skills* - Untrained or inexperienced presenters suggest that listeners lose interest and may not understand the contents of the message being conveyed.

- *Poor or negative body language* - This can result in listeners being put off as they focus on the negative vibes being displayed rather than listening intently to the speaker.

- *Inaccurately transmitted gossip* - This tends to exist in tall hierarchical organizations (see Chapter 8) where messages have to be passed through many layers so communication tends to slow down and messages can get distorted. It also occurs when there is informal communication, with messages not being clearly and accurately communicated between people.

- *Physiological barriers* - Physical and biological factors such as hearing or sight impediments can also hinder the effectiveness of communication.

- *Cultural ignorance* - A lack of cultural awareness and understanding can cause offense to others. By contrast, HSBC's slogans '*The World's Local Bank*' and '*Together We Thrive*' suggest the company is aware of different cultures in the countries where they operate.

- *Language proficiency* - This is a highly valued communication skill in today's ever-more competitive labour market. For example, English is the official business language in much of Asia and Africa but fluency in native languages such as Mandarin (the most spoken language in Asia) and Swahili (the most spoken language in Africa) are also vital in many occupations in these parts of the world. Staff at Disneyland Paris in Chessy, France must be bilingual in French and English. This helps to reduce the impact that language and cultural differences can have as a barrier to effective communication.



Figure 12.11 - Tourist operators in Paris employ staff who are fluent in both French and English

Poor communication, caused by barriers to effective communication, hinders businesses and their operations. Consequences of poor communication include:

- Low morale will exist as staff feel out of touch, lose confidence and have a lack of direction. They may therefore feel under-valued and demotivated (see Chapter 10).

- Errors and mistakes will rise as staff are not fully aware of what they have to do. Hence, tasks might need to be reworked. This creates wastage and thus increases costs. On an international scale, communication problems can occur due to language and cultural barriers, which may hinder trade. Marketing mistakes not only cost money but can harm a firm's corporate image if the messages are offensive to other cultures (see Chapter 34).

- There will be a loss of competitiveness due to the lower productivity, caused by poor staff morale and the increase in errors, mistakes and reworking.

- A lack of coordination and control can transpire as employees may need clear instructions from their managers. Equally, managers will need feedback and commitment from their staff to fulfil organizational objectives.

To solve communication problems, managers must first look at the causes of the communication breakdown. A trend in many large organizations has been delayering. This means removing layers of supervisors and management from the organizational hierarchy (see Chapter 8). This is done not only to reduce costs but also to improve the speed and accuracy of communications within and beyond the organization.

Question 12.3 - The Global Office



Ever-more multi-cultural communities are making a presence in the business world. The driving forces behind this trend include globalization, greater cross-border labour mobility and government laws that prevent discrimination in the workplace. Whilst the global office can provide many benefits, there is the potential for disastrous misunderstandings to occur due to communication barriers such as differences in language, etiquette, mannerism, expectations and cultural norms.

(a) Outline why foreign language might be a hindrance to effective business communication. *[2 marks]*

(b) Explain how an awareness and knowledge of multiculturalism in the 'global office' can improve communications in the workplace. *[4 marks]*

Question 12.4 - OCR's examination paper blunder

The Oxford, Cambridge and Royal Society of Arts (OCR) Examination Board is one of the main examination boards in the UK. In the past, some 6,400 A Level Geography students were forced to sit an incomplete exam paper because OCR failed to send schools copies of a map that was required for a question worth 16 marks. The blunder by the examination board meant that students had to overlook the question that was worth more than 20% of the exam paper. In 2018, the exam board was fined £175,000 ($245,000) for a blunder in a GCSE English Literature exam that left around 14,000 students being unable to answer a question about Shakespeare's Romeo and Juliet, one of the most famous plays in the world.

These mistakes enraged teachers and parents alike since OCR's error placed extra stress on students. OCR responded by stating that the questions would be ignored during the marking process and launched an investigation into how the slip-ups occurred.

(a) Explain **two** barriers to effective communication. *[4 marks]*

(b) Examine the importance of effective communication to an organization such as the OCR Examination Board. *[6 marks]*

Theory of Knowledge (TOK)

If a manager cannot communicate something to others, can this still be considered as understanding and knowledge?

Communication and the key concepts

The art of communication is crucial to any sustainable business strategy. Unless managers and leaders can communicate effectively organizational goals are unlikely to ever be achieved. Effective communication is important during times of change, such as when firms grow through mergers and acquisitions (see Chapter 5) in order to minimize any resistance to change in the workplace (see Chapter 7). It is also important during times of crises when effective communication is a crucial factor in determining the success of a crisis management plan (see Chapter 41).

The objectives of introducing new and improved changes to communication systems in an organization include:

- Improved speed, access and accuracy of communication.
- Improved motivation and productivity as the use of better communications technologies should reduce errors, reworking and workloads.
- Greater potential to reach a wider audience, especially with the use of digital communication technologies such as company websites and social media apps.

However, there are limitations of introducing new and improved changes to a firm's communications systems. These include:

- *Costs* - New equipment might not be compatible with existing software or hardware and this represents wastage or a need for more capital expenditure (see Chapter 14) to replace obsolete equipment.
- *Threats to security* - The growing importance of and reliance on information and communication technologies also brings about their threats, such as data privacy, online security risks, unauthorized access, website downtime risks and online fraud (see Chapter 43).
- *The need for change management* - Any organizational change needs to be managed effectively, which can be a highly complex and expensive task (see Chapter 7).

At the same time, managers and decision makers must be aware that **information overload** can be demotivating. This happens when staff are swamped with too much communication which increases their workload and stress level. For example, this often happens to new members of staff during their induction training (see Chapter 10). It can also occur when a business pursues organizational change. Furthermore, if information is passive or written documents are too lengthy, then employees may regard such communications as *hygiene* factors (factors that can cause dissatisfaction - see Chapter 10).

Today, most managers hold the view that it is both ethical and right to listen to the views of their staff, especially if workers are regarded to be the firm's most valuable assets. This can help to foster better employer-employee relations (see Chapter 13). It is also important to listen to the views of employees for motivational and productivity reasons. Workers are hired for their expertise and having their input in decision-making can sometimes generate creative ideas for business strategy. Indeed, the Japanese have been using such methods successfully for many years (see Chapter 37 about quality circles). Management guru Peter F. Drucker (1909 - 2005) argued on similar lines that the most important things are sometimes simply the messages not being communicated. As Steve Jobs (1955 - 2011), co-founder of Apple, once said so well, "*It doesn't make sense to hire smart people and tell them what to do. We hire smart people so they can tell us what to do.*"

ATL Activity 12.1 (Research skills)

Investigate how effective communication impacts the success of an organization of your choice. Be prepared to share your findings with the rest of the class.

Theory of Knowledge (TOK)

If a manager does not know how to communicate something to the staff of an organization, can this constitute knowledge?

Theory of Knowledge (TOK)

Discuss how language can be used to influence, persuade or manipulate employees in the workplace.

REVIEW QUESTIONS

1. In a business context, what is meant by communication?
2. Why is effective communication important for the running of a business?
3. What is meant by channels of communication?
4. How does internal communication differ from external communication?
5. How does formal communication differ from informal communication?
6. How do open channels of communication differ from restricted channels of communication?
7. What is verbal communication?
8. What is written communication?
9. What is visual communication?
10. What is non-verbal communication?
11. How has the use of information communication technology (ICT) improved business communications?
12. What is meant by barriers to communication?
13. What are the main examples of barriers to communication?
14. What are the consequences of poor communication?
15. What is information overload?

KEY TERMS

Barriers to communication refer to anything that can limit or impede the effectiveness of communications, thereby leading to information failure. Examples include jargon, ignorance, internal politics and computer failure.

The **channel of communication** refers to the method(s) through which communications take place between the sender and recipient.

Communication is the transfer of information between different people and between organizations.

Electronic mail refers to the process of using computer wide area networks (WAN) as a mailing system for communication purposes.

External communication is conducted between members of one organization and members of another.

Formal communication refers to the official and established channels of communication.

Grapevine communication covers all aspects of communication through unofficial (informal) channels.

Jargon is specialist or technical language used to speed up communication.

Informal communication (or **grapevine communication**) refers to unofficial, natural and unstructured channels of communication, naturally established by people from within an organization.

Information overload is the excessive amount of information being passed onto staff, i.e. swamping workers with too much communication. This can increase workload and stress.

Internal communication refers to communications within the business organization.

Internal politics refers to conflict between people within an organization.

Non-verbal communication is any form of communication other than oral communication, such as electronic systems (such as email), written methods (such as letters) and visual stimulus (such as body language).

Open channels of communication are used when information is not confidential and can be shared by anyone.

Restricted channels of communication are used when information is confidential and is directed only to those who need to know.

Verbal communication (or **oral communication**) refers to communication via the use of spoken words, such as meetings, interviews and appraisals.

Videoconferencing is a communication method that allows communications to take place via telecommunications networks. The parties can see and hear each other using videoconferencing hardware and software technology.

Visual communication is the use of visual stimuli to communicate information or ideas.

Written communication refers to communication methods that make use of the written word, such as letters, memoranda, reports and notices.



Figure 12.12 -Letters are a form of written communication

Chapter 13
2.7 - Industrial/employee relations (HL only)

HIGHER LEVEL

"The voice of the people is louder than the boom of a canon."
- Armenian Proverb

Contents

2.7 Industrial/employee relations (HL only)	
HL content	**Depth of teaching**
Sources of conflict in the workplace	AO2
Approaches to conflict in the workplace by: • Employees: (i) collective bargaining, (ii) work-to-rule and (iii) strike action • Employers: (i) collective bargaining, (ii) threats of redundancies, (iii) changes of contract, (iv) closure and (v) lockouts.	AO3
The following approaches to conflict resolution: • Conciliation and arbitration Employee participation and industrial democracy No-strike agreement Single-union agreement	AO3

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Sources of conflict in the workplace (AO2)

Conflict refers to a situation of resistance or mutually exclusive goals between two or more parties, such as employees and employers. It is caused by disagreements or incompatibilities between these groups and results in a lack of cooperation and cohesiveness. Conflict in the workplace can arise at different levels, ranging from interpersonal conflict between individuals to international conflict between regional directors of a company.

Sources of conflict in the workplace arise from differences in the following factors for different stakeholders:

- *Needs and wants* - Conflicts arise when people's needs and desires are ignored or not met. For example, employees want job security and competitive pay and remuneration. Conflict often arises due to differences in opinions over rates of pay and working conditions. For instance, introducing flexible working practices (see Chapter 7) may suit some people, such as part-time staff, but not others due to restructuring or redundancies.
- *Perceptions* - Different people interpret things differently. What annoys one person does not necessarily bother others. Misunderstandings and misperceptions can easily lead to conflict. For example, some people are receptive to change whilst others are opposed to change perhaps due to their ignorance. Hence, there is a crucial role for effective communication to unite perceptions if conflict and resistance to change are to be minimized (see Chapter 7).

HIGHER LEVEL

- *Values* - Conflict can arise when people hold incompatible beliefs, values or principles. If people are intolerant and unwilling to compromise, this can make the management of conflict a very challenging task.

- *Power* - Conflict can arise when people in a position of power try to make others do something against their will. The perceived injustice or exploitative use of authority causes conflict in the workplace. For example, managers might place pressure on employees to meet unrealistic sales targets or production deadlines.

- *Feelings and emotions* - Conflict often occurs because people ignore the feelings and emotions of others in the organization. It is quite natural for a person to feel let down or upset when others disagree with their ideas, recommendations or opinions. It is not easy to simply separate professional life from personal life so feelings and emotions can become a major influence over how people deal with conflict. For example, grievances in the workplace or gossiping often lead to permanent conflict as people find it hard to forget and forgive those who they feel have been unfair or unreasonable.

In summary, conflict can result from differences in the attitudes, beliefs, values or needs of different people. It can also arise from past rivalries and personality clashes.



Figure 13.1 - Conflict can result from differences in attitudes, beliefs, values and needs

Conflict in the workplace becomes a problem if it is not managed properly, because it can:

- Lower the level of staff morale due to added stress and anxieties.

- Reduce productivity as there is less focus on completing the task at hand.

- Cause inappropriate conduct at work, such as unethical behaviour.

- Fuel the internal politics (incompatible differences) within an organization.

- Limit opportunities for collaborative teams and weakens team cohesiveness.

However, note that conflict in the workplace is not necessarily a negative thing. Some analysts believe that conflict is often needed in organizations. For instance, conflict can help to raise and address real problems that are bothering people. It can also help people to recognise and benefit from their individual differences and personal perspectives. Having a better understanding of each other's differences and needs can actually foster better working relationships in the future. Conflict itself is not the true problem; it is the way in which conflict arises and how it is managed that can become problems.

Theory of Knowledge (TOK)

Are perceptions, emotions, or reasoning the main sources of conflict?

Theory of Knowledge (TOK)

How might emotions affect our perceptions on inequalities in the workplace?

Approaches to conflict in the workplace by employees (AO3)

Approaches to conflict in the workplace by employees: (i) collective bargaining, (ii) work-to-rule and (iii) strike action. AO3

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Employees are usually represented by a **trade union** (or **labour union**) in their approach to conflict in the workplace. This is an organization whose members unite to protect their employment rights and welfare. Employee representatives coordinate industrial action in cases of industrial disputes. **Industrial action** refers to the activities taken by disgruntled employees due to disputes about pay and/or terms and conditions of work. It is a result of poor employer-employee relationships or conflict at work.

The primary role of labour unions is to protect the interests of their members, such as:

- Increased pay (or the prevention of pay cuts as is often the case).
- Improved remuneration, such as fringe benefits and paid holidays.
- Better working terms and conditions, such as hours of work and rest breaks.
- Opportunities for training, development and career progression.
- Better-quality staff facilities, such as an improved staff canteen or working spaces.

An individual is unlikely to have much bargaining power compared with a union of workers due to the strength in numbers. From an employer's perspective, it is also cheaper and quicker to bargain with just one trade union representative than many individual workers. Box 13.1 outlines the main types of labour unions.

Members of a trade union pay an annual fee to cover the costs of running the labour union. Examples of the main issues that labour unions are occupied with are outlined in Box 13.2. Membership fees also contribute towards the costs of legal advice and representation for members in the case of grievances or other form of industrial disputes.

Box 13.1 - Types of labour unions

- *Craft unions* - These were the original labour unions with members sharing a particular skill or craft, such as engineers or printers.
- *Industrial unions* - These trade unions accept members from the same industry, irrespective of their skills, qualifications, rank or the nature of their work.
- *General unions* - Such labour unions accept members from any industry, regardless of their skills or qualifications, so they tend to have a very large membership.
- *White-collar unions* - These trade unions admit clerical, administrative and professional staff as members are non-manual workers. They exist in professions such as teaching, accountancy, healthcare and banking.

Box 13.2 - Typical activities of labour unions

- Negotiating with employer representatives for increased pay and benefits.
- Improving the terms and conditions of work for their members, such as working hours and rest breaks.
- Providing union members with necessary legal advice, as and when needed.
- Offering financial support and legal advice to members who might have been unfairly dismissed or made redundant.
- Upholding the rights of their members to have professional training and development.
- Protecting members' health and safety rights at work, such as by pressurising employers to ensure that equipment and machinery are safe to use.
- Lobbying the government to pass legislation in favour of workers, such as minimum wage laws.

HIGHER LEVEL



Figure 13.2 - Labour unions fight for health and safety laws to protect employees

Employees and trade union members use the following approaches to conflict resolution in the workplace: (i) collective bargaining, (ii) work-to-rule and (iii) strike action.

(i) Collective bargaining

Collective bargaining is the negotiation process whereby trade union representatives and employer representatives discuss issues with the intention of reaching a mutually acceptable agreement. Individual employees are unlikely to be in a good position to negotiate with their employers. However, this weakness is removed when the workforce is united, via trade union representation. Subsequently, senior managers are more pressurised to listen to the views of the workers. A united workforce benefits from an increase in its collective bargaining (negotiation) power during the conflict resolution process.

(ii) Work-to-rule

Work-to-rule occurs when employees do the absolute minimum required according to the rules set by the employer. Workers adhere precisely to all rules and regulations in their deliberate attempts to delay production and to reduce productivity. Any goodwill from staff is withdrawn; workers do no more than they absolutely need to. For example, office staff may refuse to answer telephone calls during lunch breaks or choose to leave work as soon as their scheduled shift finishes. Such industrial action is considered less disruptive than strike action as workers are simply just obeying rules and regulations in a meticulous manner. Hence, employers find it more difficult to discipline staff who work to rule.

A variation of work-to-rule is **go-slows**. This involves employees working at the minimum pace allowable in their employment contract as they adhere to every organization rule and policy. This reduces productivity yet employers find it difficult to discipline staff who work at a slow but contractually acceptable pace, following internal rules and procedures. Overtime work is avoided (as there is no rule or requirement to do so) and any sense of urgency ceases as employees seek to minimise the speed of their work. Go-slows can be highly effective for workers when businesses face imminent deadlines or during periods of high seasonal demand because their operations become extremely disrupted.

Theory of Knowledge (TOK)



The EU's Working Time Directive (2003) states that all workers in the European Union must not be required to work more than 48 hours in a week, with a minimum rest period of at least 11 hours a day. Workers must be offered at least 28 days (four weeks) in paid holidays each year. How can we know if such employment laws are beneficial to employers and employees?

(iii) Strike action

Strike action is an extreme form of industrial action taken by employees as it involves the collective refusal to work. It is usually the result of major industrial unrest, such as widespread pay disputes or serious grievances. Strike action is only considered to be official if it has the backing of the majority of members of a trade union. The labour union usually carries out a vote on whether members are in favour of strike action and then gives notification of such intent to the management if industrial action is to go ahead. Workers carry out strike action as a sign of protest or disapproval of management decisions and

actions. It is hoped that strike action forces an agreement to be reached with the employer.

Strike action used to be a powerful method used by employees and labour unions to get their demands met. However, changes in social attitudes and legislation in many countries have meant that there are laws to protect employers from the potential power and threat of trade unions. Strike action can obviously be very disruptive to a business and governments try to ensure that businesses can operate fairly and competitively, without the added pressures imposed by trade unions. For example, in many countries it is illegal for a labour union to call for strike action from its members without giving prior notice to the employer. This allows the management to formulate contingency plans (see Chapter 42) as the business will obviously be disrupted by the proposed industrial action.

A variation of strike action is **walk-outs**. A walk-out is a form of industrial action that happens when employees independently or collectively leave (or walk out of) their place of work as a sign of protest or disapproval of management decisions and actions.



Figure 13.3 - Public protests are a method of expressing employee rights in the workplace

Nevertheless, trade unions have steadily declined in popularity across most parts of the world. Fewer people tend to be joining labour unions, for a variety of reasons. For example, automation and mechanisation in some industries have led to redundancies in the manufacturing sector (traditionally the largest sector for trade union workers). A range of government rules and legislation has also led to weakening trade union powers, thereby making them less attractive to members. Finally, more part-time employees in the workforce have led to a decline in union membership (as they tend not to be unionised). As a consequence, many organizations have developed **staff associations.** These have similar roles to a trade union except that they operate only within the organization. Hence, the issues dealt with by a staff association are more relevant to the workers, although their bargaining strength is weaker than that of a general labour union.

Whichever method of industrial action is used, the output and efficiency of the business suffers, at least temporarily. This reduces the competitiveness and profits of the organization, with the intention of making the employer respond to the demands of the workforce.

ATL Activity 13.1 (Research skills)

Investigate a major industrial dispute for a company of your choice. What did the management team learn from this process? Be prepared to share your findings with the rest of the class.

Theory of Knowledge (TOK)

Discuss how it might be possible to know how much maternity leave (paid and/or unpaid) women should be entitled to.

Theory of Knowledge (TOK)

What are the knowledge issues involved in determining what is considered to be an acceptable salary to remunerate workers?

HIGHER LEVEL

Question 13.1 - Deutsche Telekom

Deutsche Telekom is one of Europe's largest telecommunications companies, with over 226,000 workers and sales revenue in excess of €101bn ($116bn). Although the German company experienced short-term walk-outs in the past, it had not experienced full strike action until 2007 when over 11,000 employees went on strike over proposed pay cuts and increased working hours. Deutsche Telekom, parent company of mobile phone giant T-Mobile, argued that the proposals were necessary as almost a million customers had left its fixed-line business, having switched to cheaper rivals. In 2018, Deutsche Telekom and T-Mobile workers across the USA and Germany took further industrial action by going on strike again over further pay disputes.

(a) Define the term *strike action*. *[2 marks]*

(b) Define the term *industrial action*. *[2 marks]*

(c) Explain **two** sources of conflict at Deutsche Telekom. *[6 marks]*

Question 13.2 - Indonesia's national strike action

In October 2020, **labour unions** in Indonesia called for nationwide **industrial action** over poor workers' rights in the world's fourth most populous country. Government proposals included the scrapping of mandatory paid maternity leave, as well as paid leave for weddings and bereavements. Employee representatives also argued that the cost of living had risen sharply due to a combination of inflation (mainly caused by rising fuel prices and higher rents) and minimum wages being capped by the government. Factory workers complained about being among the lowest paid in Asia, earning less than their counterparts in China and India. Government representatives responded by stating that the changes were needed to make Indonesia attractive to investors, especially after the negative impacts of the COVID-19 pandemic causing millions of job losses across the country.

(a) (i) Define the term *labour unions*. *[2 marks]*

(ii) Define the term *industrial action*. *[2 marks]*

(b) Explain **two** methods that labour unions in Indonesia could use to protect the interests of their members. *[6 marks]*

Approaches to conflict in the workplace by employers (AO3)

Approaches to conflict in the workplace by employers: (i) collective bargaining, (ii) threats of redundancies, (iii) changes of contract, (iv) closure and (v) lockouts.

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Employer representatives are individuals or organizations that represent the leadership team in the process. Some employers use a specialist management consultancy firm, whilst others prefer to use a small team of highly skilled individuals on the senior leadership team. In large organizations, the employer representatives are often from the company's Head Office. These representatives act as the authorized representative and contact people for the employer. Employers can also use **employers' associations**. These are organizations that represent the general views and interests of all businesses within a certain industry by negotiating with unions and influencing government action. Employer associations can also offer advisory business-related services. The approaches to conflict in the workplace by employers are: (i) collective bargaining, (ii) threats of redundancies, (iii) changes of contract, (iv) closure and (v) lockouts.

(i) Collective bargaining

Collective bargaining refers to the process by which industrial disputes are settled by negotiations between employers and employees or by their respective representatives. Collective bargaining differs from other forms of conflict resolution in that it does not require the involvement of third parties to establish a win-win situation. Collective bargaining covers a range of employment matters, including pay, benefits, working hours, paid leave (such as holiday pay, maternity leave and paternity leave), health and safety in the workplace and work-life balance.

Employers seek to maximise their position by using skilled negotiation techniques. For example, skilled negotiators often use deadlines as a tactic in the negotiation process. Setting short deadlines often gives the opposition less time to prepare or fight for their case.



Figure 13.4 - Collective bargaining strives for a win-win resolution

(ii) Threats of redundancies

Some negotiators use threats of redundancies as a method of intimidation to pressurise or warn employees to cooperate otherwise their jobs are at risk. For example, during times of conflict, senior managers might use the threat of redundancies to force workers into complying with their demands. However, this does not mean that employers can simply mistreat or fire employees as they are protected by employment laws.

Case study 13.1 - Arik Air

Nigeria's Arik Air fired an unspecified number of pilots in December 2021, caused by industrial unrest and the failure to serve a strike notice prior as required by national employment laws. The purpose was to send a warning to all other union members to refrain from taking further industrial action.

Theory of Knowledge (TOK)

Is there anything ethical about threatening employees in a negotiation process?

HIGHER LEVEL

Human resource management

HIGHER LEVEL

(iii) Changes of contract

It may be possible for employers to legally change people's contracts of employment, if administered fairly and transparently. For example, if staff are on finite contracts, then it is possible to change the terms and conditions of pay when renewing their contracts. This gives the business a degree of flexibility in its pay structure and added strength in the negotiation process to resolve conflict in the workplace. However, this can be seen as a form of coercion as those who do not accept the new terms and conditions of the contract are simply denied the opportunity to extend their employment.

(iv) Closure

One way that managers can deal with strike action is to close the business. This is a rather extreme method, which is used when other approaches have been exhausted and when unions reject the employer's final offer. At best, closure means that workers will not receive any wages. In the worst-case scenario, extended periods of closure can mean that workers are made redundant and permanently lose their jobs. This ultimatum might be enough to force or persuade employees to renegotiate or to settle for a compromise.

(v) Lockouts

Lockouts occur when the employer temporarily stops employees from working during an industrial dispute. This is the opposite of a strike when the employees refuse to turn up for work. The business might hire security guards and/or change the safety locks of the premises to prevent employees from entering the workplace. The lockout will, in theory, eventually put pressure on people to return to work in order to get paid. A divided trade union soon becomes a dysfunctional group.



Figure 13.5 - A lockout prevents workers from accessing the workplace

Case study 13.2 - Qantas

In October 2011, Qantas imposed a lockout due to an on-going labour union dispute. The Australian airline grounded all domestic and international flights, despite the estimated financial loss of A$20m ($17.9m) per day and affecting 68,000 customers. The government intervened several days later to force a stop to the lockout due to the mounting damage caused to the Australian economy.

Approaches to conflict resolution (AO3)

The following approaches to conflict resolution: (i) conciliation and arbitration, (ii) employee participation and industrial democracy, (iii) no-strike agreement and (iv) single-union agreement.

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Conflict resolution refers to the course of action taken to resolve conflict and differences in the workplace. It is considered to be successful if each party's interests are addressed, resulting in a satisfactory outcome for all sides. Given that employers and employees may have conflicting interests, it can be difficult for both sides to reach a settlement. There are four ways to approach conflict resolution stated in the syllabus: (i) conciliation and arbitration, (ii) employee participation and industrial democracy, (iii) no-strike agreements and (iii) single-union agreements.



Figure 13.6 - Conflict resolution is an important managerial skill

(i) Conciliation and arbitration

Conciliation is a process whereby the parties involved in a dispute agree to use the services of an independent mediator. This person meets with the parties separately and in private (a practice known as **caucusing**) in an attempt to resolve their disputes and differences. The conciliator's role is to encourage the parties to negotiate and compromise to reach a solution that is mutually acceptable (see Figure 13.7). The parties are unlikely to ever actually meet so it is important for conciliators to be highly skilled negotiators and effective communicators. Conciliators will almost always get the parties to commit their compromise in writing, which makes the resolution legally binding.

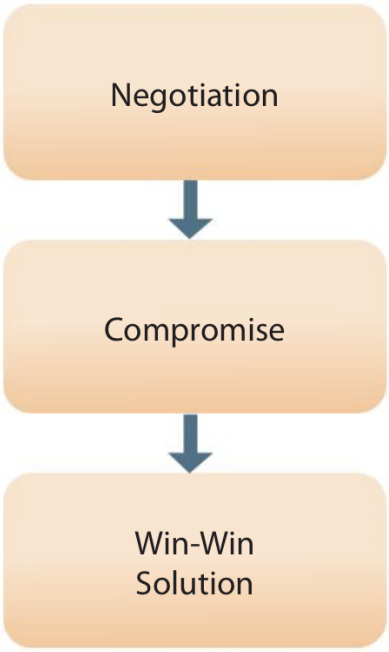

Figure 13.7 - The three-step conciliation process

Arbitration is similar to conciliation in that an external entity is used as part of the conflict resolution process. However, this method involves an independent arbitrator deciding on an appropriate outcome. The arbitrator acts rather like a judge by listening to and examining the arguments put forward by both parties before making a final decision or recommendation. The arbitrator's decision becomes final and legally binding.

An extreme case of arbitration is **pendulum arbitration** which requires the arbitrator to decide completely in favour of one party or the other, i.e. there is no compromise made. The idea behind this approach is that both parties in the dispute are forced to make more realistic and/or conservative demands. For example, suppose that there is conflict over the rate of pay rises, with the labour union pushing for 6% but employers arguing for only 3%. The arbitrator will need to assess both sides of the argument. If the arbitrator calculates that 4% is the correct level for pay increments, this is closer to the 3% advocated by the employer and therefore the decision will be to raise pay by 3%.

(ii) Employee participation and industrial democracy

Employee participation means that workers are given responsibilities and authority to complete tasks and are involved in the decision-making process. It is an example of industrial democracy. **Industrial democracy** refers to the involvement of workers in the decision-making process of an organization. An example of employee participation is team working (see Chapter 10). Motivation theorists such as Maslow and Herzberg (also see Chapter 10) point out that employee participation and industrial democracy help to increase productivity because workers are more involved in their work so are happier. Another example is the use of suggestion schemes, which give employees the opportunity to provide managers with their own ideas and suggestions for improvements in the workplace.

Furthermore, greater employee participation in the workplace means that employers benefit from a more cooperative workforce that is less likely to engage in industrial action. Employees also benefit from higher levels of morale and an increase in job satisfaction. As a result, staff absenteeism and labour turnover rates (see Chapter 10) are also likely to fall. In theory, these benefits lead to a 'win-win' situation for both the employer and employees.

(iii) No-strike agreements

A **no-strike agreement** is a method of conflict resolution involving members of a labour union in agreement not to strike as a form of industrial action. Many trade unions have been negatively affected by their image for being disruptive to the business community. Trade union membership throughout the world has also been declining. In response to these trends, many labour unions have tried to improve their image by having a no-strike policy or a no-strike agreement with employers. This means that trade union members agree not to go on strike as an extreme form of industrial action. For example, the American Federation of Teachers, with around 1.7 million members across the USA, has a no strike policy. This has helped the second largest trade union for teachers in the USA to sustain its membership and reassured employers and other stakeholder groups that teachers will not strike at the expense of their students.

HIGHER LEVEL

(iv) Single-union agreements

A single-union agreement occurs when an organization agrees to participate in the negotiation process with a sole labour union that represents the workers. The benefit of a single-union agreement is that it causes fewer disruptions to the employer as there is no need to spend as much management time and resources dealing with a multitude of problems from various inter-union disputes.

In reality, the approach taken to deal with conflict largely depends on people's concern for their own outcomes and that of others. This means that there are five possible outcomes:

- High concern for personal outcomes leads people to **compete** for a win-only outcome. This can lead to further and ongoing disputes between the parties.
- High concern for others only means **surrendering**, which leads to a win situation for the other party.
- Low or no concern for either party's outcomes simply means there is **avoidance** of the issue causing conflict.
- High concern for the outcome of both parties leads to **collaboration** (cooperation) to find a mutually beneficial solution to the conflict. In theory, this is the optimal strategy to approach conflict resolution.
- Moderate concern for the outcome of both parties leads to some sort of **compromise.**

Most experts believe that high concern for the outcome of both parties (and hence efforts to find a mutually beneficial resolution) leads to the most acceptable outcome for all parties involved. However, each strategy will be appropriate in different circumstances and at different times. Collaboration, for example, does not work for all cases of conflict.

Overall, the outcome of any approach to conflict in the workplace depends on the relative negotiation and bargaining strengths of the employer and employee representatives. These in turn depend on several factors, including:

- *The level of experience and skills of the negotiators or representatives* - As with all negotiations, those with more skills and experiences tend to be in a stronger position to have their demands met.
- *The number of members and the degree of unity within the trade union* - Labour unions tend to be more powerful if members are united and if a majority of the workforce belong to the trade union.
- *The state of the economy* - For example, employees are in a weaker position to negotiate pay rises if there is a recession and high unemployment in the economy.
- *The level of demand for a product* - The demand for labour is unsustainable if prospects for a good or service are unfavourable, as this weakens the bargaining power of employees and their representatives.
- *Public and media opinion* - Support from the general public and/or mass media for the business or labour union may determine which party has stronger negotiating powers.
- *Government intervention* - Government rules and regulations often determine the parameters within which negotiations take place and the relative bargaining power of labour unions and employer representatives.

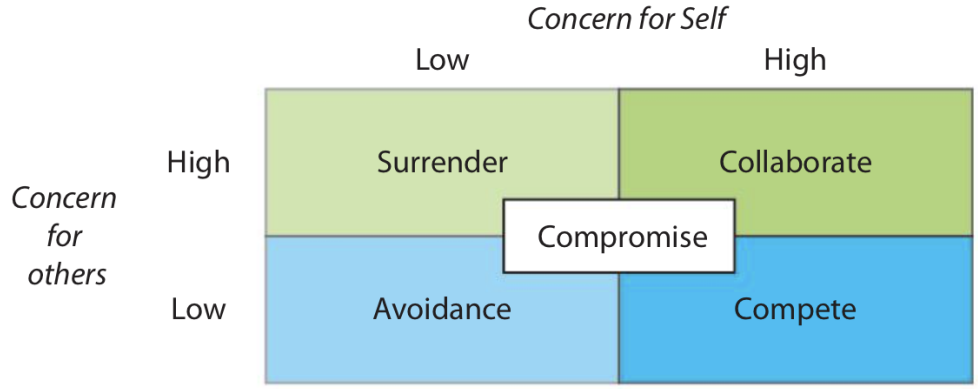

Figure 13.8 - Outcomes of and approaches to conflict

HIGHER LEVEL

Question 13.3 - Human Rights Watch and Walmart

Human Rights Watch is an international **non-governmental organization** based in New York. In 2007, it carried out its first ever survey on how American companies treat their workers (having previously conducted studies in other countries). Human Rights Watch found that Walmart, the largest employer in the USA, had violated federal laws by its aggressive efforts to shut out trade unions. The report found that none of the 1.3 million Walmart staff was associated with a labour union. Independent reports also suggested that Walmart employees were disgruntled over the lack of **corporate social responsibility**, especially the poor pay and working conditions.

Following protests by thousands of Walmart workers, Human Rights Watch claimed that "*Walmart has repeatedly used tactics that run afoul of US law and directly infringe on workers' right to freedom of association.*" Walmart responded by defending that it provided open channels of communication to allow employees to express their ideas, comments and concerns. Walmart also claimed that its labour practices meant that none of the workers needed to join labour unions, further testifying that the accusations made in the Human Rights Watch report were outdated and misleading.

In 2019 Walmart paid $5.2 million to resolve disability discrimination allegations filed by the US Equal Employment Opportunity Commission (EEOC). In 2020, Walmart also paid $14 million to settle a pregnancy discrimination lawsuit and another $20 million to resolve a gender discrimination lawsuit brought by the EEOC.

(a) (i) Define the term *non-governmental organization.* *[2 marks]*

(ii) Define the term *corporate social responsibility.* *[2 marks]*

(b) Explain how a perceived lack of corporate social responsibility at Walmart can cause conflict in the workplace. *[6 marks]*

(c) Evaluate alternative approaches to conflict resolution at Walmart. *[10 marks]*

Theory of Knowledge (TOK)

Is there ever a case for senior managers to surrender to, or avoid, conflict? Are these signs of poor leadership?

Industrial-employee relations and the key concepts

Change and creativity in the workplace often involves the implementation of new processes and technologies in an organization. This includes technologies that support or improve the performance of employees and the quality of their work. Consider, for example, how learning technologies in education have changed the way that teachers and students work. Such changes can therefore improve employee motivation, efficiency and commitment. However, labour-saving technologies and innovations can harm employer-employee relations, especially if such changes lead to mass job losses. Such conflicts can then cause job insecurity, demotivation, poorer quality work and lower productivity.

Ethical considerations include the implementation of corporate social responsibilities (see Chapter 3), such as the ethical treatment of workers. For example, employers who provide workers with adequate rest breaks, equal opportunities and prospects for career development are more likely to get the best out of their employees, who get to enjoy a good work-life balance (see Box 13.3). By contrast, employees who are mistreated, discriminated against or overstretched struggle to have a positive working relationship with their employers. This is more likely to lead to ongoing conflicts in the workplace.

HIGHER LEVEL

Box 13.3 - Work practices that support employees' work-life balance

- Policies and practices to reduce workloads.
- Flexible working practices, such as part-time, flexitime and teleworking (see Chapter 7).
- Job-sharing (a highly flexible form of part-time work with two people sharing the work of a single full-time position).
- Flexibility in the allocation of paid vacation time.
- Allowing leave of absence from the workplace for a variety of reasons, such as maternity, paternity and adoption leave as well as for sickness.

Finally, it is an imperative to consider the needs of workers and to treat staff in an appropriate and ethical manner if they are truly regarded as the organization's most valuable asset. After all, it is the employees who persuade and serve customers to part with their money. Therefore, open and trusting employee-employer relations, conducted in ethical ways, help to enhance the strategic direction and sustainability of an organization.

Business Management Toolkit

Discuss how cultural differences can also influence employer-employee relations. You may find it useful to refer to Chapter 11 (organizational culture) and Chapter 54 (Hofstede's cultural dimensions).

Theory of Knowledge (TOK)

Is it possible to measure happiness in the workplace in a truly objective way? Can we therefore measure the correlation between happiness and productivity, or do we simply know by intuition?

Theory of Knowledge (TOK)

Is compromise irrational and a sign of weak leadership and management?

Key concept

Change creates conflict just as equally as conflict creates change. To what extent do you agree with this statement?

Key concept

Discuss how perceptions of **ethics** can create conflict in the workplace.

Key concept

With reference to an organization you have studied, discuss how **change** and **ethics** have influenced employer-employee relations.

REVIEW QUESTIONS

1. What is meant by conflict?
2. What are the main sources of conflict in the workplace?
3. Why does conflict become a problem if not managed properly?
4. What are labour unions (trade unions)?
5. What are the typical activities of labour unions?
6. What is collective bargaining?
7. What is work-to-rule?
8. How does a walk-out differ from strike action?
9. What are employer's representatives?
10. What is meant by industrial action?
11. What is meant by collective bargaining?
12. How do employers use threats of redundancies as a method of conflict resolution?
13. How do employers use changes of employment contracts as a method of conflict resolution?
14. How do closures differ from lockouts?
15. What is meant by conflict resolution?

B How does conciliation differ from arbitration?

17. What is meant by employee participation and industrial democracy?
18. Why might employee participation and industrial democracy lead to a win-win outcome?
19. What are no-strike agreements?
20. What are single-union agreements

KEY TERMS

Arbitration is the process that involves an independent person or body (the arbitrator) deciding on an appropriate outcome to a dispute. The arbitrator's final decision is legally binding.

Closure is an extreme method used by employers to deal with industrial disputes by closing the business in order to force or persuade workers to renegotiate or to settle for a compromise.

Collective bargaining is the negotiation process whereby trade union representatives and employer representatives discuss issues with the intention of reaching a mutually acceptable agreement.

Conciliation is the process whereby the two parties involved in a dispute agree to use the services of an independent mediator to help in the negotiations.

Conflict refers to a situation of resistance or mutually exclusive goals between two or more parties. It is caused by disagreements or incompatibilities between these groups and results in a lack of cooperation and cohesiveness.

Conflict resolution refers to the course of action taken to manage and resolve conflict or differences in opinions.

Employee participation is an example of industrial democracy that involves employees being given responsibilities and authority to complete tasks. It directly involves workers in the decision-making process.

Employer representatives are individuals or organizations that represent the management or leadership team in the collective bargaining process.

Industrial action refers to the activities taken by disgruntled employees due to disputes about pay and/or terms and conditions of work.

Industrial democracy refers to the involvement of workers in the decision-making process of an organization.

Lockouts occur when the employer temporarily stops employees from working during an industrial dispute.

A **no-strike agreement** is a method of conflict resolution involving members of a labour union in agreement not to strike as a form of industrial action.

HIGHER LEVEL

A **single-union agreement** refers to employers agreeing to participate in collective bargaining with a sole trade union that represents the workers.

Strike action is a form of industrial action that involves employees refusing to turn up for work. This is usually the result of major industrial unrest such as large-scale pay disputes.

Threats of redundancies are a method of intimidation to pressure or warn employees to cooperate, otherwise their jobs are at risk.

A **trade union** (or **labour union**) is an organization of worker-members who unite to protect their employment rights and welfare.

Work-to-rule occurs when employees do the absolute minimum required, as stated in their employment contracts. This is done by adhering precisely to all rules and regulations of the organization in order to reduce productivity.



Figure 13.6 - Strike action is taken as an extreme measure to protect the rights of workers

Chapter 14
Unit 3.1 - Introduction to finance

"A business that makes nothing but money is a poor kind of business."
- Henry Ford (1863 - 1947), Founder of the Ford Motor Company

Contents

3.1 Introduction to finance	
SL/HL content	**Depth of teaching**
Role of finance for businesses: • capital expenditure • revenue expenditure	AO2

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Introduction to finance

Role of finance for businesses: (i) capital expenditure and (ii) revenue expenditure. AO2

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The role or purpose of finance for businesses can be categorized either as capital or revenue expenditure (see Table 14.1).

Capital expenditure is the finance spent on **fixed assets** (or **non-current assets**). These are items of monetary value that have a long-term function for businesses, so can be used repeatedly. Fixed assets are not intended to be sold (in the short term) but used for the purpose of production. Examples include land, buildings, equipment, machinery and commercial vehicles.

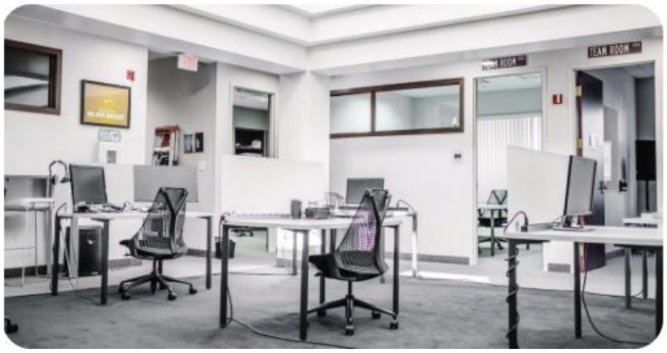

Figure 14.1 - Spending on office equipment is an example of capital expenditure

Expenditure on fixed assets has long-term benefits for the organization. It also determines the scale of an organization's operations. The sources of finance for capital expenditure tend to come from long-term sources (see Chapter 15) because of the high cost of financing fixed assets. These assets can also provide **collateral** (financial guarantees) for securing additional loan capital to finance investment expenditure for business growth.

Reasons for capital expenditure (or investment expenditure) in businesses include:

- To add extra production capacity as the business grows.
- To improve efficiency by utilizing the latest technologies, including IT systems and production technologies.
- To replace worn-out, damaged and/or obsolete (outdated) capital equipment and machinery.
- To comply with changing legislation and regulations, such as green technologies.

The main challenges of capital expenditure for most businesses are the high costs involved and the limited sources of finance available for such investments. Hence, despite the potential opportunities of capital expenditure, some investments are simply not feasible. In making capital expenditure decisions, managers often have to consider the expected return on investment by using methods of investment appraisal (see Chapter 21).



Figure 14.2 - Payment of bills (invoices) is an example of revenue expenditure

Revenue expenditure refers to finance spent on the daily operations of a business, such as the payment for wages, salaries, raw materials, rent and utility bills. Revenue expenditure also includes the payment of indirect costs (see Chapter 15) such as insurance and advertising spending.

Revenue expenditure generates value to the business today, rather than in the future. Expenses are incurred by businesses as a result of producing goods and services, which in turn generates revenue for the organization. However, costs must be controlled so that the firm's sales revenue is sufficient to cover production costs, thereby enabling the business to earn profit.

Table 14.1 - Examples of capital expenditures and revenue expenditures

Capital expenditures	Revenue expenditures
• Capital equipment	• Advertising and promotion
• Furniture, fixtures and fittings	• Energy costs
• Computer and IT systems	• Freight and delivery
• Intellectual property	• Insurance
• Machinery	• Office supplies and administration
• Mergers and acquisitions	• Raw materials and components
• Property and premises	• Rent
• Vehicles	• Wages and salaries

Question 14.1 - The London Olympic Games

London made history by becoming the first city to host the modern Olympic Games three times (1908, 1948 and 2012). The commercial benefits were welcomed by the UK construction industry, with around half a million new jobs added to the industry in preparation for the most-watched global sporting event. Transport for London, the local government body responsible for most of the transport networks in London, funded numerous improvements in preparation for 2012, including expansion of railway networks and the introduction of Britain's first 'bullet' (high-speed rail) trains.



(a) With reference to the case study, distinguish between *revenue expenditure* and *capital expenditure.* *[4 marks]*

(b) Examine the benefits of the Olympic Games being held in London to various stakeholder groups. *[6 marks]*

Different businesses have different access to an array of sources of finance (see Chapter 15). Typically, the main source of finance for sole traders is their personal savings. By contrast, larger and more established businesses can seek other sources of finance for capital expenditure purposes, such as selling shares on a stock exchange.

Business Management Toolkit

How might knowledge of the external environment (see Chapter 46) help managers make better informed decisions about revenue and capital expenditure.

Introduction to finance and the key concepts

Capital expenditure is important for implementing change in business organizations. For example, the growing number of people working from home (see Chapter 7) has meant that businesses have had to invest in computer hardware and software to support their employees working remotely. This includes expenses on mobile devices, such as laptops and smartphones, as well as subscriptions to cloud-based software platforms.

Businesses also have to invest in their future in order to remain relevant and competitive in the market. Businesses can collapse because of the lack of sufficient capital expenditure in order to adapt to changes in the external environment, such as changing consumer trends and competitors moving in a different strategic direction (see Box 14.1). Furthermore, revenue expenditure, such as attractive and competitive remuneration packages help to motivate the workforce (see chapter 10) and improve productivity and employee loyalty to the organization. Hence, both revenue and capital expenditure are vital for the sustainability of business organizations.

Box 14.1 - Five examples of failed businesses

- *Blockbuster Video* - Founded in 1985 and the global leader in video rentals once employed 84,300 workers across 9,094 stores worldwide. However, the company collapsed in 2010 due to its inability to transition to digital technologies such as online streaming services.
- *Borders* - The international book and music retailer had stores around the world but was unable to transition to the new business environment of digital and online books and music. With mounting debts, the company went bankrupt in 2011.
- *Kodak* - Once the world's largest film company, the American brand failed to recognise the need to invest in digital production technologies. Its hesitation to fully embrace the shift to developing digital cameras for the mass market led to its demise in 2012.
- *Tower Records* - The mega-store music retailer was in 1960, selling a range of CDs, cassette tapes, DVDs, electronic gadgets, video games, accessories and toys. Although the company moved online in 1995, it accrued excessive debts and failed to keep up with digital disruptions such as Apple's iTunes and the growth of streaming businesses such as Spotify. This led to the company's bankruptcy in 2004.
- *Toys "R" Us* - Once the world's largest toy retailer, the American company missed the opportunity to develop its own e-commerce presence early on to compete with the likes of Amazon. Far too late, the company announced in May 2017 its $100 million plan to revamp its e-commerce platform but debts of $1bn and intense online competition led to the company's bankruptcy in September 2017.

Theory of Knowledge (TOK)

How can managers know what to invest in?

Key concept

Discuss whether capital expenditure enhances or limits **creativity** in business organizations?

REVIEW QUESTIONS

1. What is capital expenditure?
2. What are some typical examples of capital expenditure?
3. What is revenue expenditure?
4. What are some typical examples of revenue expenditure?
5. How does capital expenditure differ from revenue expenditure?

KEY TERMS

Capital expenditure refers to investment spending on fixed assets, such as the purchase of machinery, equipment, land and buildings.

Collateral refers to the financial guarantee for securing external loan capital to finance investment expenditure for business growth.

Fixed assets (or **non-current assets**) are items of monetary value that have a long-term function for businesses, so can be used repeatedly for the purpose of production.

Revenue expenditure refers to spending on the day-to-day running of a business, such as payment of rent, wages, salaries and utility bills.



Figure 14.3 - Paying invoices and bills is part of a firm's revenue expenditure

Chapter 15
Unit 3.2 - Sources of finance

"Never spend your money before you have earned it."
- Thomas Jefferson (1743 - 1826), 3rd President of USA (1801 - 1809)

Contents

3.2 Sources of finance	
SL/HL content	**Depth of teaching**
The following internal sources of finance: • Personal funds (for sole traders) • Retained profit • Sale of assets	AO2
The following external sources of finance: • Share capital • Loan capital • Overdrafts • Trade credit • Crowdfunding • Leasing • Microfinance providers • Business angels	AO2
Appropriateness of short- or long-term sources of finance for a given situation	AO3

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Sources of finance

All businesses and organizations need money to finance their various activities. This could be for the initial setting up of the business, for its day-to-day running (revenue expenditure) or for expansion purposes (capital expenditure). Businesses can obtain their finance from a range of sources, such as loans from a bank or by selling shares.

Sources of finance is the general term used to refer to where or how businesses obtain their funds. These can be categorised as internal or external. The syllabus also requires you to be able to understand the appropriateness of these sources of finance for different situations.



Figure 15.1 - All businesses need sources of finance to operate

Internal sources of finance (AO2)

The following internal sources of finance: (i) personal funds (for sole traders), (ii) retained profit and (iii) the sale of assets. AO2

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Internal sources of finance refer to money or funds that come from within the business. These include the following:

(i) Personal funds

This refers to the use of an entrepreneur's own savings. Personal funds (sometimes referred to as **owner's capital**) are usually used to finance business start-ups. It is the main source of finance for sole traders (see Chapter 2). For example, Jamie Oliver, the famous British celebrity chef, hired fifteen unknown recruits for his restaurant 'Fifteen', using £500,000 ($720,000) of his own money to fund the business venture. For most sole traders, personal funds are insufficient, so they need to use additional sources of finance.

(ii) Retained profit

This is the value of profits that a business keeps (after paying taxes to the government and dividends to its shareholders) to use within the organization. Retained profit is often used for capital expenditure (investing in the business by purchasing and/or upgrading fixed assets). Some retained profit might also be kept in a contingency fund (see Chapter 41) in case of emergencies, crises and unforeseeable expenditure in the future. The benefit of retained profit as a source of finance is that it does not incur any interest charges.

(iii)The sale of assets

Existing businesses can sell their dormant assets (unused assets), such as selling obsolete machinery and old computer equipment that have recently been replaced. If a business has chosen to relocate (see Chapter 38), it might be able to raise finance through the sale of land and buildings. In more extreme cases, businesses can raise external finance by selling subsidiaries in response to a major liquidity threat to its survival.

External sources of finance (AO2)

The following external sources of finance: (i) share capital, (ii) loan capital, (iii) overdrafts, (iv) trade credit, (v) crowdfunding, (vi) leasing, (vii) microfinance providers and (viii) business angels.

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External sources of finance refer to money or funds that come from outside the business. The main external sources of finance are outlined in the section below.

(i) Share capital

Share capital is the money raised from selling shares in a limited liability company. For publicly held companies (see Chapter 2), this comes from its initial public offering (IPO) and any subsequent share issues. Share capital is the main source of finance for most limited liability companies and is recorded in the company's balance sheet (see Chapter 17). The key advantage is that it can provide a huge amount of finance. For example, Brazilian oil company Petrobras raised a world record $70 billion from a public share issue in September 2010.

Privately held companies cannot sell their shares to the general public whereas publicly held companies can issue their shares on a stock exchange. The main functions of a stock exchange (or stock market) are to enable companies to raise capital and to provide a market for second-hand shares and government stocks. The London, Tokyo and New York Stock Exchanges are among the largest in the world.



Figure 15.2 - The New York Stock Exchange, Lower Manhattan, New York City

Many businesses decide to 'go public' by floating their shares on a stock exchange for the first time. This is known as an **initial public offering** (IPO). Popular IPOs are heavily oversubscribed (see Box 15.1), which pushes up the share price. Existing publicly held companies can raise further finance by selling more shares in a **share issue** (or a **share placement**) on a stock exchange. However, by issuing shares, ownership and control of

the company becomes diluted. The process also involves many legalities and administrative procedures, with their associated costs.

Common mistake

Students often write that a fall in a company's share price affects its level of profits as the firm has less money. It is more likely to be the other way round; the poor performance of a company will lead to a fall in its value, meaning its share price subsequently declines.

Exam tip !

When shareholders sell their shares, the company does not receive any of this money as these shares are traded on the secondary market of the stock exchange; no new shares have been issued by the company.

Box 15.1 - The world's 10 largest IPOs

Company	Country	Year	Funds raised (USD)
1.Saudi Aramco	Saudi Arabi	2019	$29.4bn
2. Alibaba.com	China	2014	$25.0bn
3. SoftBank Group	Japan	2018	$23.5bn
4. Agriculture Bank of China	China	2010	$22.1bn
5. Industrial and Commercial Bank of China	China	2006	$21.9bn
6. American International Assurance	USA	2010	$20.5bn
7. Visa Inc.	USA	2008	$19.7bn
8. General Motors	USA	2010	$18.2bn
9. NTT Docomo	Japan	1998	$18.1bn
10. Enel	Italy	1999	$16.6bn

Sources: adapted from BusinessInsider.com

Question 15.1 - Agricultural Bank of China (ABC)

In August 2010, Agricultural Bank of China (ABC) completed its **initial public offering** (IPO) in Shanghai and Hong Kong, raising $22.1 billion. Despite the weak market sentiment in Asian stock markets and fears that shares were generally overvalued at the time, investors poured money into one of China's largest lenders. Today, ABC has over 320 million customers across 24,000 branches. ABC's flotation proved to be the world's largest ever at the time, beating the previous record of $21.9 billion set by the IPO of China's largest bank, Industrial and Commercial Bank of China (ICBC) in October 2006.

(a) Define the term *initial public offering.* *[2 marks]*

(b) Explain why Agricultural Bank of China (ABC) might have decided to float its shares on the stock market. *[4 marks]*

(c) Explain why investors might have been so keen to buy shares in ABC, despite the weak market sentiment in Asian stock markets at the time. *[4 marks]*

(ii) Loan capital

Loan capital refers to medium- to long-term sources of finance obtained from commercial lenders such as banks. Interest charges are imposed and can be fixed or variable, depending on the agreement between the borrower and lender. The amount borrowed is paid back in instalments over a predetermined period of time, such as 5, 10 or 25 years. Examples of loan capital (sometimes referred to as **debt capital**) include:

- **Mortgages** - These are secured loans for the purchase of property (real estate) such as land or buildings. If the borrower defaults on the loan (fails to repay) then the lender can repossess (reclaim or take back) the property.
- **Business development loans** - These highly flexible loans are catered to meet the specific needs of the borrower to develop aspects of their business. They can be used for a range of purposes, such as to start or expand their business, to purchase specialist equipment and other assets or to improve an organization's cash flow position (see Chapter 20).
- **Debentures** - These are long-term loans issued by a business. Debenture holders (individuals, governments or other businesses) receive interest payments even if the business makes a loss and before shareholders are paid any dividends. The interest payment can be fixed or variable depending on the type of debenture. They are used by a vast range of organizations, from Arsenal Football Club for its Emirates Stadium in London to private schools in Hong Kong (see Question 15.2). However, unlike shareholders, debenture holders do not have ownership or voting rights. Debentures provide a long-term source of finance for businesses, without the business losing any control. However, issuing debentures increases a firm's gearing ratio (see Chapter 19). This means the business has more borrowing as a percentage of its total capital employed, so this makes the firm more vulnerable to risks if interest rates increase.

CORE

Question 15.2 - Kellett School

In 2013, Kellett School in Hong Kong introduced record-breaking **debentures** up to the value of HK$10m (US$1.29m), being refundable when students eventually leave the school. Parents with more than one child at the school would get a small discount. Its school fees ranged from HK$123,500 to HK$168,800 per year (US$15,930 to US$21,775). The timing coincided with the school's move to a new HK$200m (US$25.8m) campus with its much-improved facilities such as a large auditorium, swimming pool, Astroturf multisport areas, an extensive library and state-of-the-art classrooms.

Critics argued the enormous cost of education would diminish Hong Kong's competitiveness by putting off highly skilled expats and their families from moving to the Hong Kong Special Administrative Region of the People's Republic of China. Rival school Harrow International offers non-interest-bearing debentures of up to HK$3m (US$387,000). Capital expenditure and the costs of land construction mean that debentures are common in international schools in Hong Kong.

Source: adapted from www.thestandard.com.hk

(a) Define the term *debentures.* *[2 marks]*

(b) Outline why Kellett School might have decided to sell debentures. *[2 marks]*

(c) Despite the high price, suggest why most parents might agree to purchase Kellett School's debentures. *[4 marks]*

(d) Explain **two** potential drawbacks to a fee-paying school like Kellett School that chooses to raise finance through the sale of debentures *[4 marks]*

(e) Examine **two** alternative sources of finance that Kellett School could have used to finance its capital expenditure. *[6 marks]*



Figure 15.3 - Debentures were used to help build The Emirates Stadium, London

(iii) Overdrafts

Overdrafts are a financial service that allows a business to temporarily overdraw on its bank account, i.e. to take out more money than it has in the account. Overdrafts are commonly used when businesses have minor cash flow problems (see Chapter 20). Hence, they are the most flexible form of borrowing for most businesses in the short-term. Although overdrafts can demand a relatively high rate of interest, they are usually more cost effective than bank loans. This is because, unlike bank loans, overdrafts are used as short-term sources of finance and interest is charged on a daily basis if and only if, a business overdraws on its account.

Overdrafts are suitable when there is a need for a large cash outflow, such as retailers stocking up for peak seasonal trading periods. They are also suitable for businesses that have sold products on trade credit (see below) and are awaiting payments from their customers. However, a major disadvantage is that overdrafts are repayable on demand from the lender. Nevertheless, overdrafts provide flexibility for businesses that might occasionally face cash flow problems.

(iv) Trade credit

This source of finance allows a business to postpone payments or to 'buy now and pay later'. Although a sale is made at the time of purchase, the seller or credit provider does not receive any cash from the buyer until a later date. Organizations that offer trade credit (known as **creditors**) usually allow between 30-60 days for their customers (known as **debtors**) to pay.

Being allowed to postpone payments to suppliers can help to ease a firm's cash flow problems. **Credit cards** are similar to trade credit except that the creditor is not a supplier but a financial institution such as commercial banks that offer electronic funds transfers through providers such as American Express and Visa. Essentially this acts as a cash advance to the credit card holder. Credit cards are a vital source of external finance for sole traders and partnerships.

(v) Crowdfunding

Crowdfunding is a way of raising finance from a large number of individuals for a small amount of money to finance a new business venture or project. This is the opposite of the traditional method of borrowing a large sum of money from a small number of lenders or financiers. Crowdfunding usually relies on online social media platforms, for which there is a charge for hosting such services. Crowdfunding also depends on traditional networks of friends, family and work colleagues, in order to raise money (sources of finance) for start-up businesses.

Depending on the cause, it may be possible to raise money through donation crowdfunding, with individuals making contributions for which the business does not have to pay back. The more creative or innovative the person is, the more likely they are to be able to use crowdfunding to source funds for new business ventures, projects or ideas.

However, crowdfunding is not a typical source of finance from those businesses. In many countries crowdfunding is heavily regulated in order to protect donors and to prevent fraudulent business activities. Business start-ups often try to use crowdfunding as a platform to pitch their idea and raise finance, but this usually results in some loss of ownership and control as investors demand the right to shares in the new company.

(vi) Leasing

Leasing is a form of hiring whereby a contract is agreed between a leasing company (the lessor) and the customer (the lessee). The lessee pays rental income to hire assets from the lessor, who is the legal owner of the assets. It can be cheaper to lease assets such as machinery, equipment, computers, motor vehicles and buildings, especially in the short to medium term.

Leasing is suitable for business customers who do not have the initial capital to buy such assets. This consequently releases cash for other purposes within the business. Another benefit to the lessee is that repairs and maintenance are the responsibility of the lessor. Also, as spending on leased assets is classed as a business expense, this can help to reduce the tax bill of the lessee.

The main disadvantage for the customer is that in the long term, leasing is more expensive than hire purchase or the outright purchase of the assets. **Sale-and-leaseback** involves a business selling a particular fixed asset (to raise finance) and immediately leasing the property back. In essence, the business transfers ownership although the asset does not physically leave the business.



Figure 15.4 - Police cars are often financed by leasing

Instead of leasing, some firms use hire purchase (HP), which allows them to pay their creditors in instalments, perhaps over 12 or 24 months. The asset is legally the property of the creditor until all payments have been made. Quite often, a deposit (or down payment) is required to secure a HP deal from the lender. Also, if the buyer defaults on the agreement (falls behind on repayments) then the lender can repossess the asset. HP is a form of buying on credit, so interest is charged by the lender on the amount borrowed. It is different from leasing because the buyer eventually owns the asset on payment of the last instalment.

Question 15.3 - Wizz Air

In late 2013, Hungary's low-cost airline carrier Wizz Air signed a **sale-and-leaseback** agreement with China's CDB Leasing Co. to finance six Airbus A320 aircraft. The deal raised $549 million to finance Wizz Air's expansion plans with new routes to Barcelona, Bologna, Dortmund and Rome from 2014.

The COVID-19 pandemic devastated all airline companies. In 2020, Wizz Air registered a total of 16.6 million passengers, which was only 42% of the 40 million passengers who flew with the airline during the previous year. The airline's CEO said the company hoped that air transport would be restored to pre-pandemic levels by 2024 or 2025.

Established in 2003, the airline flies to 150 destinations in 44 countries. As is common with low-cost budget airlines, Wizz Air operates a 'buy on board' system whereby food and beverages are paid for on board rather than included in the ticket price.

(a) Describe the meaning of *sale-and-leaseback* as a source of finance. *[2 marks]*

(b) Explain **two** advantages to businesses such as CDB Leasing Co. opting to lease expensive assets to established companies such as Wizz Air. *[4 marks]*

(c) Explain **two** advantages to Wizz Air choosing to lease some of its aircraft. *[4 marks]*

(vii) Microfinance providers

Microfinance is a type of financial service aimed at entrepreneurs of small businesses, especially females and those on low incomes. As a social enterprise (see Chapter 2), microfinance providers enable disadvantaged members of society to gain access to essential financial services to help eradicate poverty.

Without these businesses, access to banking and insurance services is very limited for small businesses; quite often, finance is only available from unofficial money lenders at extremely high costs to the borrower. The funds are approved for microenterprise development. According to the World Bank, over 500 million individuals have directly benefited from access to microfinance. According to the World Bank, nearly 3 billion people in low-income countries have little or no access to official financial services to help them increase their earnings and standards of living.



Figure 15.5 - Microfinance has helped women in Vietnam to earn a living

Case study 15.1 - BRAC

Formerly known as the Bangladesh Rural Advancement Committee, BRAC is the largest microfinance provider in Bangladesh. Founded in 1972, its headquarters are in Dhaka, Bangladesh. According to its website (http://www.brac.net/), BRAC has over 97,700 staff members, most of whom are women and has helped more than 126 million people with its services in 11 different countries.

(viii) Business angels

Business angels are extremely wealthy individuals who choose to invest their own money in businesses that offer high growth potential, i.e. high-risk, high-return business ventures. They provide funding for firms that are unable to secure sufficient finance from commercial banks and/or are too small to attract the attention of shareholders or other investors.

Business angels are likely to take a proactive role in the setting up or running of the business venture. This means that the owner loses some control to the business angel. Another disadvantage is that the organization might eventually have to buy out the stake owned by the business angel if it wishes to regain control and ownership. However, with their abundance of experience and financial backing, business angels can be a major advantage to the survival and success of a new business.

Table 15.1 - The advantages and disadvantages of microfinance providers

Advantages of microfinance providers	Disadvantages of microfinance providers
Accessibility - Microfinance helps those in poverty to become financially independent, whereas commercial banks do not typically lend such small amounts and to this particular demographic.	*Immorality* - Critics argue that microfinance is an unethical operation as the microfinance providers are for-profit organizations. Hence, they profit from the poor and the unemployed.
Job creation - The effective use of microfinance can help to create new job opportunities, with beneficial effects on society as a whole.	*Limited finance* - Microfinance providers only offer small amounts of money to borrowers because of the high risk of default (failure to repay loans).
Social wellbeing - Successful applicants who receive microfinance are less likely to pull their children out of school. The opportunities also provide recipients better access to healthcare services for their families.	*Limited eligibility* - Not all poor individuals qualify for microfinance. As for-profit organizations, microfinance providers have to minimize their own risks by ensuring borrowers have the ability to repay their loans.

Business angels consider a number of criteria before committing their capital in an investment project, including:

- *Return on investment* - Investors demand a positive return on their investment. A majority of business start-ups fail outright, so each investment has to have good potential to be highly profitable.
- *The business plan* - This document outlines the purpose or goals of the business venture. The purpose creates direction and an identity for the business, which is central to securing finance from investors. Business angels need to feel confident that the business fully understands the market in which it operates. They want to see that the business idea allows the firm to compete in a high-growth market with few competitors. Creative and original ideas are needed to convince investors to part with their money.
- *People* - It is extremely difficult for any individual to have all the skills, experiences and contacts required to run a business successfully. Essentially, no matter how good an idea might be in the business plan, success will only materialize if the business has a good team of people. Ineffective people management is a major cause of business failure, so this is an important factor that business angels will examine carefully.
- *Track record* - Investors will assess the past track record of a business (such as its earning history) and its management before investing any money. This might include an assessment of the firm's record of repaying previous lenders on time and the past achievements of the entrepreneurs.



Figure 15.6 - Business angels provide finance to back business ideas with high potential returns

Case study 15.2 - Business angels in the UK

According to the UK Business Angels Association (UKBAA), approximately 18,000 business angels invest about £1.5 billion ($2.1bn) in the UK each year. The typical business angel invests about £40,000 ($65,500) and is driven by being able to help others to succeed in business and invests in a business for up to eight years. Interestingly, only about 5% of Britain's angel investors are female.

Source: adapted from https://www.ukbaa.org.uk/

Question 15.4 - Tawfeer Market

Tawfeer Market is an Egyptian online grocery retail business founded in 2020. The business delivers groceries to customers in Alexandria, Egypt's second most populated city. In early 2022, Tawfeer Market raised $500,000 from **business angels**. Online grocery retail is expected to grow exponentially in Egypt. Ahmad Fasseeh, co-founder and CEO of Tawfeer, reported that Egypt's grocery retail market exceeds $50 billion, so the owners expect more competitors to enter the market. The co-founders used the name "Tawfeer" as it means "savings" in Arabic.

(a) Define the *business angels*. *[2 marks]*

(b) Explain **two** limitations of using business angels as a source of finance. *[4 marks]*

(c) Explain how the profitability of a business, such as Tawfeer Market, affects its ability to obtain external sources of finance. *[4 marks]*

Table 15.2 - Summary of business ownership and sources of finance

	Sole traders	Partnerships	Private limited company	Public limited company	Non-profit organization
Business angels	✓	✓	✓		
Crowdfunding	✓	✓	✓		
Donations / gifts					✓
Leasing	✓	✓	✓	✓	✓
Loan capital	✓	✓	✓	✓	✓
Microfinance providers	✓				✓
Overdrafts	✓	✓	✓	✓	✓
Personal funds	✓	✓			
Retained profit (surplus)	✓	✓	✓	✓	✓
Sale of assets			✓	✓	
Share capital			✓	✓	
Trade credit	✓	✓	✓	✓	✓

Key concept

Is **creativity** compromised due to the lack of access to sources of finance for many businesses?

Short- and long-term sources of finance (AO3)

Appropriateness of short- or long-term sources of finance for a given situation. AO3

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The appropriateness of the various sources of finance depends on several factors, including the size and type of business organization, the time scale involved and the purpose of the finance. For example, a sole trader is likely to use personal funds for setting up the business, whereas a multinational company might seek external sources of finance such as share issues to expand in overseas markets.

Effective managers pay careful attention to the cash flow situation of their business (see Chapter 20) by ensuring the cash coming into the business covers the cash going out. However, problems occasionally arise so managers consider different sources of funds to deal with short- and long-term needs for finance. There is no common definition for the short and long term. However, the following definitions are in line with accounting terminology:

- **Short-term sources of finance** are those available for a period of less than one year, used to pay for the daily or routine operations of the business. In terms of external sources of finance, this means anything that has to be repaid to creditors within the current fiscal (tax) year or next twelve months. Examples include trade credit, overdrafts and crowdfunding.

- **Long-term sources of finance** are those available for any period of more than 12 months from the accounting period, used for the purchase of fixed assets or to finance the expansion of a business. Examples of long-term sources of finance include long-term loans, such as mortgages and debentures, share capital, leasing, microfinance and business angels.

Nevertheless, it is important to remember that these definitions tend to vary between businesses and industries and from

country to country. What is important is how these definitions link to the overall objectives of a business and their purpose. For example, businesses that are heavily involved in research and development (see Chapter 42), such as space technology or pharmaceuticals, might view the long-term as ten or more years, whereas fast-paced industries such as ICT and fashion might see 5 years too long ahead to plan effectively.

Table 15.3 categorizes, in a crude way, the different sources of finance under the headings of the short- and long-term.

Table 15.3 - Summary of sources of finance by time frame

	Short term	Long term
Internal sources		
Personal funds	✓	
Retained profits	✓	✓
Sale of fixed assets (divestment)	✓	
External sources		
Business angels		✓
Crowdfunding	✓	✓
Debentures		✓
Leasing		✓
Loan capital		✓
Overdrafts	✓	
Share capital		✓
Trade credit	✓	✓

Business failure is often attributed to the lack of strategic financial planning and control. Effective financial management is essential for the successful daily running of a business and for its long-term prosperity. Managers consider a number of interlinked factors when examining the strategic choice between alternative sources of finance, especially in a business environment with continual changes taking place. These factors can be remembered by the acronym SPACED:

- ***S**ize and status of firm* - An established and large multinational company will find it much easier to raise finance from a wider range of sources than a sole trader. Despite a stock market crash during 2006, the Industrial and Commercial Bank of China (ICBC) was able to raise the most substantial amount of finance for any initial public offering in history at that time (see Box 15.1). This was largely due to consumers and businesses having complete confidence in the share issue of China's biggest bank. Large organizations are also able to obtain cheaper finance due to financial economies of scale (see Chapter 6), especially as they are able to offer higher levels of collateral than smaller firms.

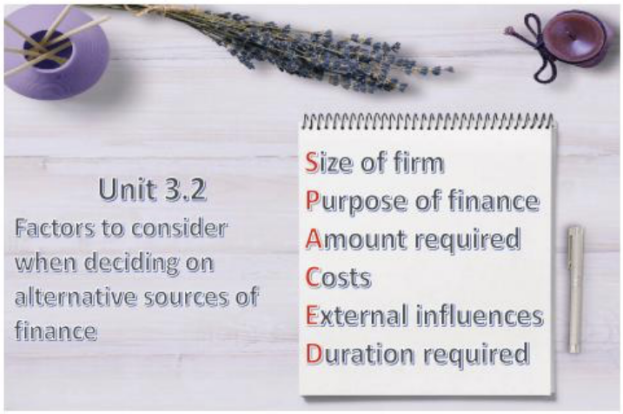
- ***P**urpose of finance* - The choice of different sources of finance depends on whether the funds are intended for the daily running of the business (short-term purposes) or for the replacement of fixed assets (long-term purposes). For example, overdrafts are more suitable for improving short-term cash flow problems (see Chapter 20), whereas leasing might be more appropriate for financing new and expensive capital equipment.

- ***A**mount required* - Large amounts of finance might be raised through an initial public offering (IPO) or through secured long-term loans from commercial banks. If a small amount of finance is needed, then retained profit or an overdraft might be sufficient. Lenders also assess the firm's existing gearing ratio (long-term external borrowing expressed as a percentage of the firm's capital employed). Businesses with a high gearing ratio are generally high risk because they have existing debt commitments. They are also more vulnerable at times when interest rates increase (which would raise their monthly repayments).

- ***C**ost of finance* - Managers need to consider the purchase cost of assets and any associated costs, such as administrative fees and maintenance charges. Higher costs tend to require long-term sources of finance, such as mortgages for the purchase of land and buildings.

- ***E**xternal factors* - Factors beyond the control of a business can have a huge impact on the strategic choice of finance. Businesses will be affected by the state of the economy and consumer confidence levels (see Chapter 46). Interest rate and stock market volatility also affect the level of consumers and producer confidence levels, thereby affecting the level of business investments. Low interest rates tend to stimulate investment expenditure because borrowing costs are lower.

- ***D**uration* - If the finance is needed for a long period of time to fund capital expenditure, such as for the purchase of a new factory or production facility, then long-term loans such as mortgages or debentures are suitable. If finance is needed to help fund working capital for the day to day running of the business (see Chapter 20), then short-term sources of finance, such as trade credit and overdrafts, are more appropriate.



Business Management Toolkit

Consider how **culture** (see Chapters 11 and 54) impacts the choice and availability of sources of finance for businesses.

For example, whilst family and friends are not explicitly featured in the Business Management syllabus as a source of finance, they are a popular source in many cultures, especially for sole traders and partnerships. For example, it is common in India for owners of small businesses to raise a significant amount of finance from close friends and family. Borrowing money from family and friends is often reasonably straight forward and inexpensive compared with borrowing from a bank, which might require collateral (security) before a loan can be authorized. However, this source of finance is usually very limited and borrowing from family and friends often provokes conflicts and disputes, irrespective of culture.

Sources of finance and the key concepts

Different sources of finance are used in different and changing business situations. However, they all serve the same purpose - to fund business activity. This is important because serious cash flow problems (when a business is unable to pay its short-term debts) can cause liquidation or bankruptcy (see Chapter 20). This is especially the case if creditors chase debtors for the money owed, but they do not have the finance to immediately repay their debts. Hence, any effective business strategy must consider the various sources of finance to ensure there are sufficient funds to run the organization in a sustainable manner.

There is also a need to consider different sources of finance as a business grows and evolves (see Chapter 5). For example, a sole trader that converts to a privately held company and then eventually trades as a publicly held company will have access to additional sources of finance. A key reason for growth strategies such as mergers and acquisitions, takeovers or strategic alliances (see chapter 5) is to be able to access a broader range of different sources of finance in order to expand the business.

Like so many aspects of business, managers must be aware of the different ethical dimensions associated with financial management. After all, the strategic choice and control of finance will have repercussions on the firm's overall financial performance. The financial accounts (profit and loss account and the balance sheet - see Chapter 17), which must be reported in a legal and ethical (transparent) way, help to reveal the degree of success of the firm's business strategy in quantitative terms.

Key concept

In the context of an organization of your choice, discuss how different sources of finance influence change and **creativity.**

REVIEW QUESTIONS

1. What is meant by sources of finance?
2. What are internal sources of finance?
3. What are internal sources of finance differ from external sources of finance?
4. What are personal funds?
5. What are retained profits?
6. How is the sale of assets a source of internal finance?
7. What is share capital?
8. What is an initial public offering (IPO)?
9. What is a share issue (or share placement)?
10. What is loan capital?
11. When is it appropriate to use an overdraft?

12. What is trade credit?
13. How does a creditor differ from a debtor?
14. What is crowdfunding?
15. What is leasing?
16. How does sale and leaseback differ from hire purchase?
17. What is microfinance?
18. Who are business angels?
19. How do short term sources of finance differ from long term sources of finance?
20. What factors do managers need to decide on before choosing their source(s) of finance?

KEY TERMS

Business angels are extremely wealthy individuals who risk their own money by investing in small to medium sized businesses that have high growth potential.

Crowdfunding is the practice of raising finance for a business venture or project by getting small amounts of money from a large number of people, usually through online platforms.

External sources of finance are the funds from outside of the organization, such as through debt (overdrafts and loan capital), share capital and business angels.

Initial public offering (IPO) refers to a business converting its legal status to a publicly traded company by floating (or selling) its shares on a stock exchange for the first time.

Internal sources of finance are funds generated from within the organization, namely through personal funds, retained profits and the sale of assets.

Leasing is a form of hiring whereby a lessee pays rental income to hire assets from the lessor, the legal owner of the assets.

Loan capital (or **debt capital**) refers to medium- to long-term sources of interest-bearing finance obtained from commercial lenders. Examples include mortgages, business development loans and debentures.

Long-term sources of finance are those available for any period of more than 12 months from the accounting period, used for the purchase of fixed assets or to finance the expansion of a business.

Microfinance is a type of financial service aimed at entrepreneurs of small businesses, especially females and those on low incomes.

Overdrafts allow a business to spend in excess of the amount in its bank account, up to a pre-determined limit. They are the most flexible form of borrowing for most businesses in the short term.

Personal funds are a source of internal finance, referring to the use of an entrepreneur's own savings. Personal funds are usually used to finance business start-ups for sole traders.

Retained profit is the value of the surplus that a business keeps to use within the business after paying corporate taxes on its profits to the government and dividend payments to its shareholders.

Sale of assets means selling existing items of value that the business owns, such as dormant assets (unused assets) and obsolete assets (outdated assets).

Share capital is the money raised from selling shares in a limited liability company.

Share issue (or **share placement**) means an existing publicly held company raises further finance by selling more of its shares.

Short-term sources of finance are those available for a period of less than one year, used to pay for the daily or routine operations of the business, such as overdrafts and trade credit.

Sources of finance is the general term used to refer to where or how businesses obtain their funds, such as from personal funds, retained profits, loan capital and share capital.

A **stock exchange** is a highly regulated marketplace where individuals and businesses can buy and/or sell shares in publicly traded companies.

Trade credit allows a business to postpone payments or to 'buy now and pay later'. The credit provider does not receive any cash from the buyer until a later date (usually allow between 30-60 days).

Chapter 16
Unit 3.3 - Costs and revenues

"Knowledge is of no value unless you put it into perspective"
- Anton P. Chekhov (1860 - 1904), Russian playwright

Contents

3.3 Costs and revenues	
SL/HL content	**Depth of teaching**
The following types of cost, using examples: • Fixed • Variable • Direct • Indirect/overhead	AO2
Total revenue and revenue streams, using examples	AO2

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Types of costs

The following types of cost, using examples: (i) fixed, (ii) variable, (iii) direct and (iv) indirect/overhead. AO2

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In everyday language, a person might say that a shirt s/he bought from a retailer "cost $25". In business language, the correct terminology is "*the price is $25*". **Cost** refers to the expenditure incurred by the business (see Table 16.1), not the actual amount paid by the customer to purchase the product from the retailer. **Price** is the sum paid by the customer to purchase a good or service

Businesses need to pay for both set-up costs and running costs. **Set-up costs** are the items of expenditure needed to start a business, such as obtaining suitable premises, purchasing machinery and equipment and deposits paid to utilities companies (gas, water, electricity and telephone). **Running costs** are the ongoing costs of operating the business, such as the payment of wages and salaries, insurance premiums and the costs of purchasing stocks (inventories).

Table 16.1 - Examples of costs for a clothes retailer

Set-up costs	Running costs
Premises, such as down payment on a mortgage or rent deposit.	Regular mortgage, rent and/or lease payments.
Buildings, such as maintenance or physical alterations to the property, as required.	Packaging materials, such as gift boxes, gift tags and wrapping paper.
Furniture, fixtures and fittings, such as changing rooms for customers, signage, counters and shelving.	Repairs and maintenance costs on buildings, furniture, fixtures and fittings due to damage or wear and tear.
Capital equipment, such as cash registers, telephones, phones, computers, printers and office stationery.	Depreciation costs on capital equipment and replacement costs for obsolete (outdate or broken) equipment.
Connection and installation of utilities and power, like telephone lines and electricity.	Payment of utilities, such as electricity and telephone bills and insurance premiums.
Legal and professional fees, including business registration and licensing.	Marketing costs, such as in-store promotions and advertising.
Initial stock of supplies (inventories).	Replenishing stocks from suppliers.
Recruitment costs of hiring, training and inducting new staff.	Wages, salaries and other staffing costs including clothing or uniform for the staff.

CORE

Exam tip !

Remember that 'cost' refers to the cost of production (which is paid by the producer) whereas 'price' refers to the amount the product is sold for (which is paid by the customer).

The following types of costs are specified in the syllabus: (i) fixed, (ii) variable, (iii) direct and (iv) indirect/overhead.

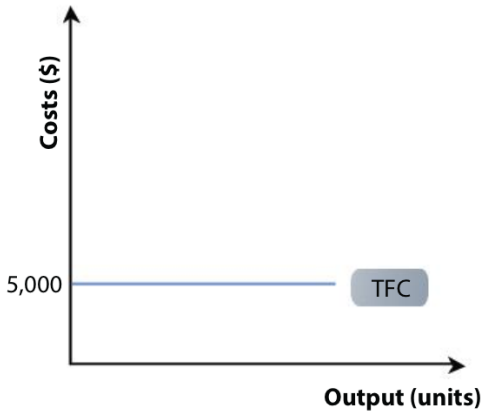

Figure 16.1 - Fixed costs of a business

(i) Fixed costs

Fixed costs are the costs of production that a business has to pay regardless of how much it produces or sells. Examples include rent on leased premises, interest payments on bank loans, advertising expenditure, market research, management salaries, office stationery, security and professional accountancy fees. These costs have to be paid even if there is no output. Hence, fixed costs are expenses that are independent of the level of output or sales. Figure 16.1 shows a business with total fixed costs (TFC) of $5,000.

Note that fixed costs can change, but this happens *independently* of the level of output. For example, a landowner might raise rents due to higher property prices in the economy or company directors are paid higher salaries due to rising costs of living. In both cases, fixed costs increase but are not directly linked to the firm's level of output or sales.

(ii) Variable costs

Variable costs are the costs of production that change in proportion with the level of output or sales. As output increases, total variable costs (TVC) also increase as illustrated in Figure 16.2. This means that if the level of output or sales doubles, then

variable costs would also double. For example, raw material costs will increase if a textiles firm makes more curtains. Other examples include the commission earned by sales staff, hourly wages of production workers and the packaging costs directly associated with output. In theory, if there is no production then the value of variable costs should be zero.

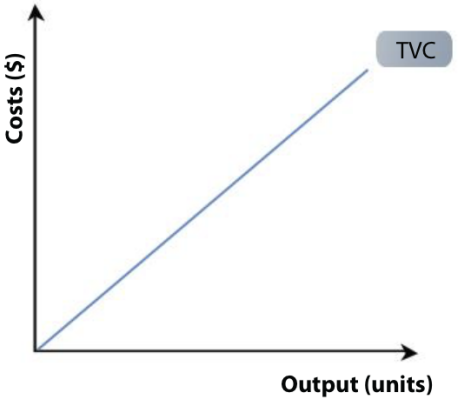

Figure 16.2 - Variable costs of a business

Adding the total variable costs to the fixed costs gives the value of **total costs** (TC). This is because total costs are the sum of variable and fixed costs, i.e. TC = TVC + TFC. It can be seen in Figure 16.3 that the TC line starts at the same value of fixed costs because these have to be paid even if there is no output. Notice that the numerical difference between the TC and TVC lines at each level of output is equal to the value of total fixed costs.

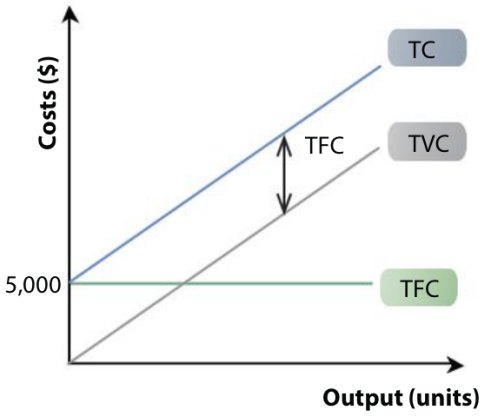

Figure 16.3 - Total costs of a business

Common mistake

Avoid writing 'circular answers' in your script, i.e. do not repeat the question in your answers. For example, when asked to distinguish between fixed and variable costs, many students simply state that "fixed costs are costs that are fixed and variable costs are costs that are variable". Review all key terms that you are unable to define clearly and accurately in your own words.

(iii) Direct costs

A **direct cost** is specifically related to an individual project or the output of a particular product; without which the costs would not be incurred. This can include variable costs such as raw materials. However, unlike variable costs, direct costs are not necessarily related to the level of output, i.e. they can be fixed costs. For example, the direct costs of purchasing a commercial building include consultancy costs, solicitor's fees, telephone bills, postage, photocopying costs and bank charges. Essentially, direct costs can be traced back to the output of a product and/or to a specific cost centre (see Chapter 22).

Note that what is a variable cost for one business is not necessarily so for another. For instance, catering costs for a flight on a mainstream airline carrier, such as Singapore Airlines, would be classified as variable costs. This is because the more passengers on the aeroplane, the more food and drinks will be required as these are included in the ticket price. However, for a 'no-frills' budget airline, such as Ryanair, easyJet and AirAsia, the catering costs are considered to be direct costs. The costs of food and drinks are directly related to the flight, but passengers do not all demand meals and drinks as these are paid for on an individual basis.

(iv) Indirect costs (overheads)

Indirect costs, also known as **overheads**, are those that cannot be clearly traced to the production or sale of any single product. For example, rent and lighting costs can be associated with all areas of a business rather than being directly related to the output of a particular product. Other generic examples of overheads include advertising, legal expenses, salaries for administrative staff, insurance premiums, security, office stationery, shipping and postage costs, utility bills and accounting fees. Indirect costs can be fixed costs as they do not directly relate to the level of output. However, unlike fixed costs, indirect costs are not easily identified with a particular business activity or the production of a particular good or service.

Exam tip !

The terms *indirect costs* and *direct costs* are used when referring to businesses that produce or sell a range of products and therefore operate 'cost centres' and 'profit centres' (see Chapter 22). These costs can be either fixed or variable costs, depending on the nature of the business. The terms *fixed costs* and *variable costs*, as used in break-even analysis (see Chapter 39), are used when referring to the sale or production of just a single type of product.

Box 16.1 - Costs formulae

Key: Q = Quantity (or level of output)

- Total Cost (TC) $TC = TFC + TVC$
- Total Variable Costs (TVC) $TVC = AVC \times Q$
- Total Fixed Costs (TFC) $TFC = AFC \times Q$
- Average Fixed Cost (AFC) $AFC = TFC \div Q$
- Average Variable Cost (AVC) $AVC = TVC \div Q$
- Average Cost (AC) $AC = TC \div Q$ or $AC = AFC + AVC$

Note: The above cost formulae are not given to candidates in the examination

CORE

Question 16.1 - Airline costs



(a) Classify the following costs for a mainstream airline company in terms of fixed or variable costs.

i. Advertising and promotions
ii. Airport charges
iii. Fuel
iv. Meals and drinks onboard
v. Remuneration of ground staff
vi. Remuneration of pilots and flight attendants. *[6 marks]*

(b) In the context of the airline industry, distinguish between **direct** and **indirect** costs. *[4 marks]*

Question 16.2 - Kompothekra Glass Technologies

Anna Kompothekra owns a factory that produces fine glass ornaments in Agia Paraskevi, Greece.



(a) Complete the table of costs for Kompothekra Glass Technologies. *[5 marks]*

Output (Units)	Total fixed costs ($)	Total variable costs ($)	Total costs ($)	Average costs ($)
0	20,000			-
100		5,000		
200		10,000		
300			34,500	
400			38,000	
500				90.0
600				97.0

(b) Using graph paper, plot the TFC, TVC and TC curves. *[4 marks]*

(c) Explain the reason for the shape of each of the three cost curves in your diagram. *[6 marks]*

Revenue

Total revenue and revenue streams, using examples. AO2

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Revenue refers to the money coming into a business, usually from the sale of goods and/or services (known as **sales revenue** or **total revenue**). The formula for calculating sales revenue is:

Sales revenue = Price × Quantity sold

For example, if Church's charges $300 on average for each pair of its bespoke shoes and sells 3,000 pairs in a week, the firm's total sales revenue will be $900,000 (i.e. $300 × 3,000) for that time period. A business earns **profit** if there is a positive difference between its revenues and costs.

Case study 16.1 - Church's



Church's is an English producer of high-end luxury footwear. Founded in 1873 by Thomas Church and his three sons, its main operations are in Northampton, UK. It can produce up to 5,000 pairs of shoes per week, with around 70% of the shoes being exported.

From humble beginnings, Church's now has retail outlets around the world including New York, Milan, Paris, Rome, Madrid, Hong Kong, Singapore and Shanghai. Since 1999, the privately held company has been owned by Prada in a deal worth $170 million.

Box 16.2 - Revenue formulae

- Total Revenue (TR) $TR = P \times Q$
- Average Revenue (AR) $AR = \frac{TR}{Q}$

since: $P = \frac{TR}{Q}$

then: $AR = P$

Note: The above revenue formulae are not given to candidates in the examination.

Question 16.3 - Big Bao

Big Bao sells a range of lunchtime meals in Bristol town centre, UK. In 2021, the business sold 31,790 units of its lunchtime meals. This represented a 10% increase in its **sales volume** from the previous year, when the average price was $6.50.

(a) Outline the meaning of *sales volume.* *[2 marks]*

(b) Calculate the value of Big Bao's sales revenue in 2020. *[2 marks]*



Question 16.4 - Goff's Organic Fresh Fruits



Ian Goff owns and manages a fresh fruits and vegetables business called Goff's Organic Fresh Fruits in a small town in California, USA. Each morning, he drives his delivery van to an out-of-town **wholesale market** to buy fresh organic fruits and vegetables. During peak seasons, Ian Goff employs two people to help him at the market stall. He pays $1,200 rent to the landlady each month. In addition, he has to pay for the loan on his one-year old vehicle plus other running costs such as power and lighting.

(a) Define the meaning of a *wholesale market.* *[2 marks]*

(b) Apart from the loan, outline two other indirect costs that Ian Goff might have to pay. *[4 marks]*

(c) Ian Goff buys his tomatoes at $0.80 per kilo. Calculate the monthly cost, revenue and profit on tomatoes if he buys 50 kg of tomatoes and sells them at $1.20 per kg. *[3 marks]*

(d) Ian Goff bought 100kg of apples this month and managed to sell 80kg of apples at the usual price of $2 per kg. To get rid of the excess stock, he reduced the price of the remaining supply to $1.50 per kg. Calculate the total revenue from the sale of apples. *[2 marks]*

Revenue streams

Revenue does not only come from the sale of goods and services. Money can come into a business from other means, collectively known as **revenue streams**, depending on the type of firm and its activities. The various revenue streams for the IB, for example, include:

- Annual fee charged to all IB World Schools
- Authorization and evaluation fees
- Donations
- Examination fees
- IB Global and Regional Conferences
- Royalties from publications and
- Workshops (training events for teachers)

Additional or alternative sources of non-sales revenue for a business can include:

- **Advertising revenue** - Companies such as Google, Twitter and Facebook rely heavily on advertising revenue as a revenue stream. For example, over 80% of the revenues from social media firm Twitter comes from text and display advertising. Google and Facebook offer *cost per click* (advertisers pay only when customers actually click on the advert) and *cost per thousand impressions* (advertisers pay based on the number of times their adverts are displayed).
- **Transactions fees** - Ryanair, for example, charges customers who pay by American Express credit card €7 ($9.5) *and* 2% commission. Other budget airlines such as AirAsia and easyJet charge fees for checked baggage, pre-assigned seats, excess baggage and onboard retailing. According to the Wall Street Journal, low-cost airlines earn around 20% of their revenue from these alternative revenue streams (see Case study 16.2).

Case study 16.2 - Revenue streams in the budget-airline industry

- SpiceJet Ltd. charges for hot meals, snacks and beverages.
- Jetstar and Scoot lend out iPads to passengers for a fee.
- AirAsia customers can pay for the privilege of being seated in a children-free quiet zone!
- Ryanair failed in its attempt to charge passengers for the use of toilets, but now offers advertising space on its planes, including on the wing tips.

- **Franchise costs and royalties** - McDonald's, Burger King and KFC all operate franchises (see Chapter 5). Franchisees pay a fee to the franchisor to purchase the right to use its brand name, logos and trademarks. The franchisee also pays a royalty payment based on the sales revenue of the franchised business. For example, the IB earns royalties from the sale of textbooks printed and distributed by the publishers that it endorses. Royalties are also received by the holder of patents and copyrights from others who are granted the use of their inventions and creations.

- **Sponsorship revenue** - Sponsorship is a form of below-the-line promotion (see Chapter 29) whereby the sponsor financially supports an organization in return for prominent promotional display of the donor's brand trademark and exclusive advertising rights. For example, Arsenal Football Club received a €132 million ($178.4m) sponsorship deal in 2006, lasting 15-year with Emirates, the largest airline of the United Arab Emirates. In 2012, this deal was extended with another $242m and a further $200m in 2018. In return, Arsenal's football shirts would carry the 'Fly Emirates' and 'Fly Better' slogans until 2024 as well as naming its sports ground the Emirates Stadium until 2028.

Table 16.2 - World's most expensive football club shirt sponsorship deals

Football Club	Shirt Sponser	£ million
Real Madrid	Emirates	413
Tottenham Hotspurs	AIA	400
Manchester United	TeamViewer	325
FC Barcelona	Rakuten	324
Bayern Munich	Deutsche Telekom	283
Arsenal FC	Emirates	280
Liverpool FC	Standard Chartered	221
Paris Saint-Germain	Accor	171
Chelsea FC	Three	166
Juventus	Jeep	159

Source: www.statista.com/statistics/1231537/football-club-shirt-sponsorship-deals/, 2021

Question 16.5 - Manchester United Football Club

In 2013, Manchester United Football Club (MUFC) become the world's first sports club to be valued at over $3 billion. Data from *Forbes* shows that match day revenues account to less than 30% of MUFC's total **revenue streams**, which also include broadcasting rights, sponsorship deals and merchandise sales across the globe.

Being one of the most widely supported sports teams in the world, the English football club attracts a huge amount of sponsorship money. In 2015, MUFC signed a 10-year shirt sponsorship deal with Adidas, worth around $108m a year. In 2021, the club signed a five-year football shirt sponsorship deal worth around $340m with German tech company TeamViewer. MUFC has also benefited from sponsorship deals with the Commercial Bank of Qatar, Emirates NBD Bank and Pepsi.

Back in 2006, MUFC chose to reject a four-year sponsorship deal worth over $100m with Mansion, an online gambling company. Instead, the senior management team opted to sign a four-year sponsorship deal with American International Group (AIG) in a deal worth $90.5m.

(a) Define the term *revenue streams*. *[2 marks]*

(b) Explain why businesses such as Adidas and Pepsi might want to sponsor a large football club such as MUFC. *[4 marks]*

(c) Examine the view that the senior management team at MUFC were correct to choose AIG as their sponsor despite the larger offer from Mansion at the time. *[6 marks]*

- **Subscription fees** - These charges are imposed on customers who use or access a good or service, based on a formal agreement. For example, fitness and leisure clubs charge yearly membership fees, many credit card companies charge annual fees, telephone companies charge a basic service fee on a monthly basis but extra for additional services (such as overseas calls and pay-per-call services), as do online streaming service providers such as Netflix and Spotify. Manchester United Football Club has operated its subscription television channel since 1998.

- **Merchandise** - Service providers in the entertainment industry (such as cinemas, concerts, theatres and theme parks) rely on selling merchandise in addition to admissions charges (such as popcorn, beverages, souvenirs and memorabilia). Facebook's customers can use its gift card service which enables consumers to use these at different retailers such as Burger King, Outback Steakhouse, Staples and Target.

- **Interest earnings** - Businesses that have a positive cash balance can earn interest on their cash deposits at a commercial bank. For highly cash-rich businesses this can be an important revenue stream. According to Macrotrends, experts in stock research and analysis, pharmaceutical giant Pfizer had a total cash balance of $12.2bn in 2021, whilst Apple had $63bn, Microsoft had $130bn and Google had $137bn. Depositing $1bn in a bank account that pays just 1% interest per year still yields $27,397 per day!



Figure 16.4 - Apple's cash balance enables it to have an additional revenue stream

- **Dividends** - Being a shareholder of other companies entitles a business to payments of any declared dividends. Dividends are a share of the net profits distributed to shareholders at the end of the tax year. For example, Europe's largest carmaker Volkswagen holds shares in Porsche, Suzuki and Scania (the Swedish maker of heavy trucks and buses).

- **Donations** - These are financial gifts from individuals or other organizations to a business. Charities and non-profit organizations (see Chapter 2) such as schools, hospitals and universities rely heavily on donations as a regular revenue stream. There are usually no direct benefits to the donor (except the feel-good factor in donating to a worthwhile cause), although some donations have terms and conditions attached, such as an appropriate acknowledgement of the donors' names in recognition of their gift. Donations are not a common source of revenue for most private sector businesses.

- **Subventions** - These are subsidies offered from the government to certain businesses to help reduce their costs of production. They are usually given to organizations that generate benefits to society, such as private schools and hospitals. Subventions are also often given to help fund research and development.

Key concept

What role does **creativity** have in developing the revenue streams of businesses?

Costs, revenues and the key concepts

Being aware of costs allows managers to be in control of their finances, especially during times of change and uncertainty. Cost control is crucial if a business is to maintain and/or improve its profitability. In particular, large businesses benefit from being able to measure the financial performance of each division of their organization. However, cost-cutting does not automatically raise profitability, but it can help to keep costs under control.

The extent to which businesses focus on cost control also depends on their organizational culture (see Chapters 11 and 54) and management preferences (see Chapter 9). Cost-cutting can be justified if it leads to improved and sustained efficiency

and profitability. However, ethical considerations occur if cost-cutting and cost control have negative impacts on staffing, such as poorer working conditions, limited opportunities for training and development, pay cuts or job losses.

Whilst cost control is important, raising revenue is just as important, if not more so. The UK Institute of Management suggests that successful businesses focus 80% of their business strategy on ways to raise revenues and only 20% on cost-cutting. Indeed, forward-looking and creative businesses can afford to spend more money provided that the revenues and profits allow it to do so. For example, Kering the French retail conglomerate bought out luxury brands Gucci and Yves Saint Laurent in order to earn more revenue - not to save on its costs.

In monitoring and overseeing a firm's costs and revenues, managers use a variety of strategies in addition to the use of cost and profit centres (see Chapter 22). For instance, budgets and variance analysis (also see Chapter 22) are critical in controlling business activity. These approaches further highlight the interrelated nature of Business Management.

Business Management Toolkit

Discuss how knowledge and application of contribution analysis (see Chapter 57) can help businesses to have better cost control.

Key concept

Some businesses use the 'FORCE' approach (Focus On Reducing Costs Everywhere) as a strategy for staying competitive.

Discuss the extent to which cost cutting is **sustainable.**

Key concept

With reference to an organization of your choice, examine how **change** and **ethics** impact on its costs and revenues.

REVIEW QUESTIONS

1. How does price differ from cost?
2. How do fixed costs differ from variable costs?
3. How are fixed costs shown diagrammatically?
4. How are variable costs shown diagrammatically?
5. How are total costs calculated?
6. How are average costs calculated?
7. What are direct costs?
8. How do direct costs differ from variable costs?
9. What are indirect (overhead) costs?
10. What is revenue?
11. How is total revenue calculated?
12. What is average revenue?
13. What is profit and how is it calculated?
14. What is meant by revenue streams?
15. What are some common examples of revenue streams for businesses?

KEY TERMS

Average cost (AC) refers to the cost per unit of output. It is calculated as AC = TC ÷ Q, where TC is total cost and Q is quantity (or output level).

Average revenue (AR) refers to the value of sales received from customers per unit of a good or service sold. It is calculated as AR = TR ÷ Q = P, where TR is total revenue.

Cost refers to the sum of money incurred by a business in the production process, such as the costs of raw materials, wages and salaries, insurance, advertising and rent.

Direct costs are costs specifically attributed to the production or sale of a particular good or service.

Fixed costs are the costs that do not vary with the level of output. They exist even if there is no output.

Indirect costs (or **overheads**) are costs that do not directly relate to the production or sale of a specific product.

Price refers to the amount of money a product is sold for. It is the sum paid by the customer to purchase a good or service.

Profit exists if there is a positive difference between a firm's total revenues and its total costs.

Revenue is the money that a business earns from the sale of goods and services. It is calculated by multiplying the unit price of each product by the quantity sold.

Revenue stream refers to the money coming into a business from its various business activities, such as sponsorship deals, merchandise and receipt of royalty payments.

Running costs are the ongoing costs of operating the business.

Set-up costs are the items of expenditure needed to start a business.

Total costs are the sum of all variable costs and all fixed costs of production.

Total revenue refers to the money coming into a business, usually from the sale of goods and/or services. It is calculated by multiplying the price of a product with the quantity sold.

Variable costs are costs of production that change in proportion to the level of output, such as raw materials and hourly wages of production workers.



Figure 16.5 - Factory workers are typically paid hourly wage rates

Topic 3: Finance and accounts

Chapter 17
Unit 3.4 - Final Accounts

"Nothing speaks more eloquently than money/"
- French Proverb

Contents

3.4 Final Accounts	
SL/HL content	**Depth of teaching**
The purpose of accounts to different stakeholders	AO2
Final accounts: • Profit and loss account • Balance sheet	AO2, AO4
Different types of intangible assets	AO2
HL content	**Depth of teaching**
Depreciation using the following methods (HL only): • Straight line method • Units of production method	AO2, AO4
Appropriateness of each depreciation method (HL only)	AO3

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The purpose of final accounts

The purpose of accounts to different stakeholders. AO2

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All businesses need to keep records of their financial statements. Whilst proper accounting allows managers to have better financial control and planning, it can also be a legal requirement. Where there is a separation of ownership and control (see Chapter 2), much of the firm's sources of finance may have come from shareholders. Financial reporting is a way to account for the money of the business, whether it belongs to the owners, investors or lenders. Hence, having to produce final accounts ensures that all payments and receipts of a business have to be officially accounted for. All companies (businesses owned by shareholders) must provide a set of final accounts to their various stakeholder groups. These **final accounts** consist of two statements:

- The **profit and loss account** - This reports the revenues and expenses of a business at the end of a specified accounting period.
- The **balance sheet** - This reports the value of assets and liabilities of a business at a particular point in time.

It is a legal requirement in most countries for companies to have their final accounts audited by independent and chartered accountants who certify the financial statements to be accurate and truthful. Incorporated businesses, which are owned by shareholders, are legally obliged to produce final accounts. This is to ensure transparency in the use of a company's funds.

However, as there is no universal method to present the final accounts, there is some degree of flexibility in reporting the financial position of a company so long as the final accounts are produced in line with the rules and regulations of the country.

Case study 17.1 - Enron

Enron was a huge America energy company, with annual sales in excess of $100 billion and a workforce of over 20,000 people. However, its dishonest accounting practices caused the company to go bankrupt in December 2001, with some of the top executives being jailed for accounting fraud. The scandal caused Enron's share price to drop from over $90 to less than $1 prior to its bankruptcy.

Despite the rise in the number of cases of fraudulent practices exposed in the news media, Luca Pacioli, regarded as the 'Father' of accounting, first wrote about the principles and ethics of accounting practices back in 1494!

Internal stakeholders such as executives and directors (see Chapter 4) can use final accounts to manage the business and to aid strategic decision-making. The purpose of final accounts for external stakeholders is to support evaluative judgements, such as the firm's ability to pay suppliers or repay financiers. The purpose of final accounts for different stakeholder groups is considered below.

- **Shareholders** - The owners of a company are interested to see where their money was spent and the return on their investments. Based on its financial performance, shareholders can decide whether to hold, sell or buy (more of) the company's shares.

- **Employees** - Staff are interested in their organization's financial accounts to assess the likelihood of or present a case for, pay rises. The final accounts can also enable employees to assess the degree of job security based on its financial position.

- **Managers** - Managers use financial accounts to judge the operational efficiency of their organizations. Financial analysis can also be useful for target setting and strategic planning.

- **Competitors** - Rival businesses are interested in the final accounts of a business to make comparisons of their financial performance (see Chapter 18).

- **Government** - The tax authority examines the final accounts of businesses, especially large multinational companies, to ensure that they pay the correct amount of tax on their corporate profits.

- **Financiers** - Financial lenders such as Commercial banks or business angels (see Chapter 15) scrutinize the accounts of a business before approving any funds.

- **Suppliers** - Suppliers examine a firm's final accounts to determine the extent to which trade credit (see Chapter 15) should be given. Suppliers need to know that their business clients are financially stable so they can be assured of receiving payments.

- **Potential investors** - Private and institutional investors use final accounts and ratio analysis (see Chapter 18 and 19) to assess whether investment in a particular business would be financially worthwhile, such as by calculating its profitability ratio, measuring its gearing ratio and determining the organization's liquidity position.



Figure 17.1 - Financiers use final accounts to judge the creditworthiness of their clients

Question 17.1 - Nestlé

Nestlé is the world's largest food company. Founded by Henri Nestlé in 1866, many of the Swiss company's brands are internationally renowned, such as Kit Kat and Smarties (confectionery), Dreyer's (ice cream), Nescafé, Nespresso, Nestea, Nesquik, Vittel and Perrier (beverages), Gerber (baby food products) and Maggi (seasoning and sauces). A huge proportion of Nestlé's revenues comes from the sale of confectionery, a market also dominated by rivals like Mars (with brands such as Snickers and M&Ms) and Cadbury's (which owns brands such as Time Out, Crème Eggs and Diary Milk). Nestlé is listed on the Swiss **stock exchange** in Zurich and employs over 352,000 people worldwide. Since 1974, Nestlé has owned a large share in L'Oreal, the world's largest cosmetics company.

(a) Outline the meaning of a *stock exchange.* *[2 marks]*

(b) Identify **two** stakeholder groups of Nestlé. *[2 marks]*

(c) Examine the importance of final accounts to both stakeholder groups mentioned in your answer to part (b). *[6 marks]*

The profit and loss account

Final accounts: Profit and loss account. AO2, AO4

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The **profit and loss account** (or the **income statement**) is a financial statement of a firm's trading activities over a period of time, usually one year. Most businesses that operate in the private sector aim to make a profit (see Chapter 3). Even for non-profit organizations and those in the public sector, it is important to make a financial surplus in order to survive. The main purpose of the profit and loss (P&L) account is to show the value of profit or loss for a business during a particular trading period.

Profit, in its simplest form, is the positive difference between a firm's revenues and its costs. **Revenues** are the inflows of money from ordinary trading activities, such as cash sales, credit sales, charges/fees charged to customers and royalties (see Chapter 15). **Costs** are the outflows of money from a business arising from its operations, such as wages, salaries, rents and the purchase of stocks (inventories). Profit creates an incentive for most businesses to do well. After all, if a business does not earn profit, it would struggle to survive.

There are three sections to the statement of profit or loss: (i) the trading account, (ii) the profit and loss account and (iii) the appropriation account.

(i) The trading account

The trading account is the first section of the P&L account and shows the difference between a firm's sales revenue (the value of products sold to customers) and its costs of producing or purchasing those products to sell. Hence, the trading account shows the **gross profit** of the business:

Gross profit = Sales revenue – Cost of goods sold

The **cost of goods sold** (COGS) is the accountant's term for the direct costs of the goods that are actually sold, such as raw material costs. COGS (or cost of sales when referring to services) is worked out by using the formula:

COGS = Opening stock + Purchases – Closing stock

For example, if a business opens trading this morning with $5,000 of stock (the cost value of the inventory) and receives a delivery of stock for which it pays $25,000 then the business has costs of stock valued at $30,000. Suppose that at the end of the trading day, the firm has $3,800 of stock remaining. Using the formula, the calculation of COGS then becomes:

COGS = $5,000 + $25,000 – $3,800 = $26,200

Thus, the COGS is $26,200. Assume that the stocks sell for three times their cost value - this would generate sales revenue of $78,600 (i.e. $26,200 × 3). Thus, the value of the firm's gross profit would be $78,600 – $26,200 = **$52,400**.

Using this example, the trading account is shown in the following format:

Statement of profit or loss for the year ended 1st April 20XX

	$	$
Sales revenue		78,600
Cost of goods Sold:		
Opening stock	5,000	
Purchases	25,000	
Closing stock	3,800	
		26,200
Gross profit		**52,400**

(ii) The profit and loss (P&L) account

The profit and loss account (or the **profit statement**) shows the **net profit** (or loss) of a business at the end of a trading period. Net profit is the financial surplus from sales revenues after all costs and expenses are accounted for. Hence, net profit is the actual profit earned from a firm's normal trading activities. The gross profit is used to deduct all expenses to calculate the value of net profit:

Net profit = Gross profit – Expenses

Expenses are the indirect or fixed costs of production (see Chapter 16), such as administration charges, management salaries, insurance premiums (for buildings, vehicles and stock), rent of land and property and stationery costs.

Suppose that Florists-R-Us sold $230,000 of stock with a market value of $460,000 during the fiscal (tax) year ended on 31st December 2022. Rents payable amounted to $90,000 whilst utility bills (gas, water, electricity and telephone) totalled $60,000. Other overheads amounted to $15,000. Note that negative numbers are shown using brackets in the P&L account to represent costs and expenses. The profit statement would then be shown as follows:

Finance and accounts

CORE

Question 17.2 - Clockworks Ltd



Refer to the information below for Clockworks Ltd. and answer the questions that follow.

- 3,000 clocks sold at $35 each
- **Closing stock** valued at $20,000
- Purchases valued at $50,000
- Stocks on 1st April 2022 were valued at $15,000

(a) Define the term *closing stock.* *[2 marks]*

(b) Construct a trading account for Clockworks Ltd. for the year ended 31 March 2022. *[4 marks]*

Profit statement for Florists-R-Us, for the year ended 31st Dec. 2022

	$	$
Sales revenue		460,000
Cost of goods Sold (COGS)		(230,000)
Gross profit		230,000
Less Expenses:		
Rents	(90,000)	
Utility bills	(60,000)	
Other overheads	(15,000)	
		(165,000)
Net profit		65,000

There are several ways that a business might try to reduce its expenses in order to increase its net profit. For example:

- Rent charges could be negotiated or the firm could consider moving to cheaper premises; although relocation might not prove feasible due to industrial inertia (see Chapter 38).
- Fuel consumption, such as heating and lighting, could be reduced. For example, businesses could turn down the heating temperature during the winter, use less air conditioning in the summer and turn off lights when not required. Such actions help to reduce electricity bills as well as helping to protect the natural environment.
- Administration costs could be examined by reviewing the work of clerical staff to reduce expenses. This might be achieved by combining jobs or employing fewer people to carry out such tasks. It might also be possible to outsource some jobs in order to reduce costs (see Chapter 38).

(iii) The appropriation account

The final section of the profit statement is called the **appropriation account**. There are two parts to this account, which show how the net profit after interest and tax is distributed:

- **Dividends** - This shows the amount of net profit after interest and tax that is distributed to the owners (shareholders) of the company. The proportion of net profit (after interest and tax) allocated to shareholders is based on the decision of the Board of Directors and is approved at the company's Annual General Meeting. It is usual for dividends to be paid bi-annually. An *interim dividend* is paid approximately midway through the year and then the *final dividend* is declared and paid at the end of the firm's fiscal year.
- **Retained profit** - This shows how much of the net profit after interest and tax is kept by the business for its own use as an internal source of finance (see chapter 15), such as reinvesting in the company or to expand its operations. Note that for non-profit organizations, the term **retained surplus** is used instead. In any case, this figure is transferred to the '*Equity*' section of the firm's balance sheet and recorded as '*retained earnings.*'

Exam tip !

Please note that you will not be asked about the trading account, profit statement and appropriation accounts in the examinations. Questions will be based on the P&L account in its entirety. Also, although the profit and loss account is also known as the income statement, the term 'profit and loss account' will be used for IB assessment purposes.

Exam tip !

What's the correct format?

Different firms in different countries use slightly different methods to present their P&L accounts. For your IB exams, use the format shown in Tables 17.1 and 17.2. Remember to place an appropriate title at the top of the P&L account.

Table 17.1 - Format of the P&L account for a profit-making organization

Statement of profit or loss for (Company name), for the year ended (date)	
	$m
Sales revenue	700
Cost of sales	(350)
Gross profit	350
Less Expenses:	(200)
Profit before interest and tax	150
Less Interest	(10)
Profit before tax	140
Less Tax	(25)
Profit for period	115
Dividends	(35)
Retained profit	80

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Table 17.2 - Format of the P&L account for a non-profit organization

Statement of profit or loss for (name of NPO), for the year ended (date)	
	$m
Sales revenue	700
Cost of sales	(350)
Gross surplus	350
Less Expenses:	(200)
Surplus before interest and tax	150
Less Interest	(10)
Surplus before tax	140
Less Tax	(25)
Surplus for period	115
Retained surplus	115

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Interest charges and taxes, despite being expenses, are shown as separate items in the P&L accounts. This is because both interest and tax rates change over time and are beyond the control of the business - profit might be lower this year only because tax or interest rates were raised. Recording profit before interest and tax allows firms to compare like with like and enables historical comparisons of financial performance. Interest is a cost as it represents the charge or fee that a business pays to its financiers such as commercial banks. Corporate tax is the levy payable on a company's profits.

Suppose that Florists-R-Us has $10,000 of interest to repay to the bank and that corporate tax is charged at 10%. By including interest and tax, the P&L account is shown as:

Statement of profit or loss for Florists-R-Us, for the year ended 31st December 2022	
	$
Sales revenue	460,000
Cost of goods sold	(230,000)
Gross profit	230,000
Expenses:	(165,000)
Profit before interest and tax	65,000
Interest	(10,000)
Profit before tax	55,000
Tax (10%)	(5,500)
Profit	**49,500**

Question 17.3 - Masks-R-Us Ltd.

An extract of this year's financial data for Masks-R-Us Ltd. for the period ended 31st August is shown below::



- Closing stock $12,000
- Interest $5,000
- Opening stock $10,000
- Overhead expenses $17,000
- Purchases $35,000
- Sales turnover 14,000 masks @ $10 each
- Tax 15% of net profit after interest

(a) Construct a full profit and loss account for Masks-R-Us Ltd. *[5 marks]*

(b) Discuss whether the performance of Masks-R-Us Ltd. can be judged solely on this quantitative information. *[10 marks]*

In reality, the three parts of the P&L account are combined into one final account. Assume that Florists-R-Us allocates 30% of its profit after interest and tax to shareholders and retains the rest for reinvestments in the company. Combining the three parts of the account will produce a full P&L account like this:

Profit & Loss account for Florists-R-Us, for the year ended 31 December 2020

	$	
Sales revenue	460,000	Trading account
Cost of Sales	(230,000)	
Gross profit	230,000	
Expenses:	(165,000)	
Profit before interest and tax	65,000	
Interest	(10,000)	Profit & Loss account
Profit before tax	55,000	
Tax (10%)	(5,500)	
Profit after interest and tax	49,500	
Dividends (30%)	(14,850)	
Retained profit (70%)	34,650	Appropriation account

Exam tip !

It is common practice for existing firms to report their P&L account for two consecutive years in order to allow for historical comparisons.

Question 17.4 - TOYS

The information below is from the profit and loss account for TOYS for the years ended 31st March. TOYS is a privately held company that sells children's toys in a busy town.

	Year 1 ($'000)	Year 2 ($'000)
Sales	450	**(i)**
Cost of sales	**(ii)**	200
Gross profit	270	300
Expenses	90	100
Profit before interest and tax	180	**(iii)**
Interest	0	10
Taxation	**(iv)**	48
Profit after interest and tax	135	142
Dividends	15	10
Retained profit	**(v)**	132



(a) Complete the missing figures (i) to (v) in the above profit and loss account for TOYS. *[5 marks]*

(b) Discuss whether the owners of TOYS would be pleased with the performance of the company. *[10 marks]*

The P&L account is important as it shows the profit (or loss) that is generated after all costs and expenses are accounted for. The gross profit might seem appealing, but if the expenses are higher than the gross profit, the business makes an overall loss. Clearly, a business cannot survive for long without making any actual profit.

There are, however, several limitations of the P&L account:

- The P&L account shows the historical financial performance of a business. There is no guarantee that future performance is linked to past performance or success.
- As there is no internationally standardized format for producing a P&L account, it might be difficult to compare the profit or loss of different firms in different countries, be they in the same or dissimilar industries.
- **Window dressing** can occur. This refers to the legal act of creative accounting by manipulating final accounts to make them appear more attractive, even though this disguises the underlying financial position of the company. For example, a company might include the sale of some fixed assets or non-operating income in its P&L account to boost the value of profits, thereby impressing its shareholders.



Figure 17.2 - Window dressing is about making a firm's products or accounts look more attractive

The balance sheet

Finance accounts: Balance sheet. AO2, AO4

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A **balance sheet** (or **statement of financial position**) is one of the annual financial statements that all limited liability companies are legally required to produce for auditing purposes. It contains information on the value of an organization's assets, liabilities and the capital invested by the owners. As it shows the financial position of a business on one particular day only (usually the last day of the firm's accounting year), it is often described as a 'snapshot' of the organization's financial situation.

It is called a balance sheet because the document shows a firm's sources of finance (shown as the *equity*) and where that money has been used (shown as the *net assets*), i.e. it reveals where a firm's money has come from (such as share capital and retained earnings) and what it has been spent on (net assets). For example, if a firm's building has a market value of $550,000 but has an outstanding mortgage of $350,000, the difference of $200,000 is the firm's equity, representing the portion of the property that the business actually owns. Thus, the balance sheet helps to ensure that all monies within the organization are properly accounted for.

It is common practice and a legal requirement in many countries, for established businesses to report the balance sheet figures for two consecutive years. This allows different stakeholder groups to make comparisons regarding the financial performance of the business.

A balance sheet must contain three essential parts: (i) assets, (ii) liabilities and (iii) equity.

(i) Assets

Assets are items of monetary value that are owned by a business, such as cash, stocks and property (premises). To purchase assets, firms need different sources of finance (see Chapter 14). Assets can be classified as either *noncurrent assets* or *current assets*.

A **noncurrent asset** (also referred to as **fixed assets**) is any asset used for business operations (rather than for selling) and is likely to last for more than 12 months from the balance sheet date. Examples include property (premises), plant (factory or production facility) and equipment.

A **current asset** refers to cash or any other liquid asset that is likely to be turned into cash within twelve months of the balance sheet date. The three main types of current assets are cash, debtors and stocks (inventories).

- **Cash** - This is the money that is held in the business or at the bank.
- **Debtors** - This refers to people or other organizations that owe money to the business as they have purchased goods on credit. The value of debtors is a current asset because the money is owed to (or belongs to) the business.
- **Stocks** - These are unsold supplies of raw materials, semi-finished goods (work-in-progress) and finished goods. Finished stocks are relatively liquid in comparison to raw materials.

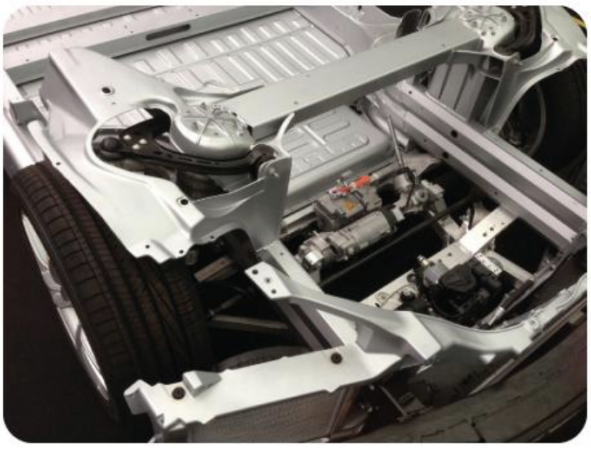

Figure 17.3 - Work-in-progress is a type of current asset for Tesla

Exam tip !

An asset belongs to a business, but this does not mean that it has been paid for. A building (asset) could be worth millions of dollars but is often funded mainly by debt (such as a mortgage), with the remaining amount being equity.

(ii) Liabilities

A **liability** is a legal obligation of a business to repay its lenders or suppliers at a later date. Hence, liabilities are the amount of money owed by the business. There are two main classifications of liabilities: (i) noncurrent liabilities and (ii) current liabilities.

Noncurrent liabilities (also known as **long-term liabilities**) are debts that are due to be repaid after twelve months of the balance sheet date. Hence, they are the firm's sources of long-term borrowing. Examples include mortgages, bank loans, debentures and any other type of long-term borrowing (see Chapter 15).

Current liabilities are debts that must be settled within one year of the balance sheet date. Examples include bank overdrafts, trade creditors and other short-term loans.

- **Bank overdrafts** - This is a short-term source of finance (see Chapter 15) that enables a business to withdraw more from its bank account than the amount that exists. Overdrafts need to be repaid quickly as interest rates tend to be very high.
- **Trade creditors** - Suppliers need to be repaid for items that have been purchased on trade credit, usually within 30 to 60 days.
- **Other short-term loans** - Businesses may have other short-term loans that fall due within 12 months of the balance sheet date.

The value of a firm's **net assets** is therefore the value of all its assets minus all its liabilities. The value of net assets must be equal to (balance with) the firm's **equity** as recorded on the balance sheet. Net assets are calculated by using the formula:

Net assets = (Noncurrent assets + Current assets) – (Noncurrent liabilities + Current liabilities)

Or

Net assets = Total assets – Total liabilities

(iii) Equity

Equity (also known as **capital and reserves**) refers to the value of the business that belongs to the owners. For limited liability companies, equity is comprised of share capital and retained earnings (the sum of accumulated retained profits). For sole traders and partnerships, only retained earnings are recorded as these entities do not have shareholders. Hence, there are two sections to this part of the balance sheet: (i) share capital and (ii) retained earnings.

- **Share capital** refers to the amount of money raised through the sale of shares. For publicly traded companies, this is done via a Stock Exchange. Share capital on a balance sheet shows the value raised when the shares were first sold, rather than their current market value.
- **Retained earnings** are the total amount of accrued profit after interest, tax and dividends have been paid. The accumulated retained profit is then reinvested in the business for its own use. This money, of course, belongs to the owners of the business so appears under owners' equity or shareholders' equity in the balance sheet. The figures for retained earnings come from the firm's P&L accounts.

Exam tip !

Retained profit appears in both the balance sheet and profit and loss account. The figure in the P&L account shows the profit (after interest and tax) that is kept within the business for its own use, rather than being distributed to the owners or shareholders in the form of dividend payments. Retained profit also appears in the 'equity' section of the firm's balance sheet because it is an internal source of finance listed as retained earnings.



Figure 17.4 - A firm's equity must balance with its net assets

From a balance sheet, we can see that:

Total assets – Total liabilities = Net assets = Total equity

This means that the owners own the value of the assets of the business after deductions have been made for all its debts.

The example below shows a balance sheet for a hypothetical chain of restaurants for a particular year, illustrating the format and terms used to construct a balance sheet. The key terms of the balance sheet are explained on the right-hand side of the table.

Statement of financial position for Bellamkonda Restaurants Ltd., as at 31st October 20XX

	$'000	$'000	
Noncurrent assets			Noncurrent assets are items owned by the firm that are not intended for resale within the next 12 months but are used to generate output and sales, e.g. the physical restaurants (premises), tables equipment, chairs, fridges, cash registers, drinks machines and air conditioning.
Property, plant & equipment		1 700	
Machinery and Equipment		500	
		2200	
Accumulated depreciation		(200)	This refers to the provisions or allowances made for the fall in the value of noncurrent assets over time, e.g. due to wear and tear of the machinery and equipment used in the restaurants.
Noncurrent assets		2 000	This is the net value of the restaurant's noncurrent assets after provisions are made for depreciation.
Current assets			Current assets are items owned by the business that are in the form of cash or what it intends to change into cash within one year of the balance sheet date, e.g. stocks (food and drinks) and debtors (customers who have paid by cheque or credit card). Current assets include cash, debtors and stocks
Cash	250		
Debtors	30		
Stocks	200		
Current assets		480	
Total assets		2480	Total assets refer to the sum of noncurrent assets plus current assets.
Current liabilities			Current liabilities are debts that the business must pay to its creditors within 12 months of the balance sheet date, e.g. money owed to the bank for overdrafts, to trade creditors (suppliers of food and drinks) and any other form of short-term borrowing.
Bank overdraft	15		
Trade creditors	250		
Other short-term loans	55		
Current liabilities		320	
Noncurrent liabilities		160	Noncurrent liabilities are the debts owed by a firm, repayable after 12 months from the balance sheet date. They are long term sources of borrowing, such as mortgages (to purchase the restaurants) and outstanding bank loans (which may have been for the purchase of machinery and equipment used in the restaurants).
Borrowings (long term)	500		
Noncurrent liabilities		500	
Total liabilities		820	This is the sum of noncurrent liabilities plus current liabilities, i.e. the total sum of money owed by the business.
Total assets		**1660**	This is the sum of total assets minus total liabilities. It must match (or balance with) the figure for the firm's equity.
Equity			Equity refers to the sum of money that belongs to the owners of the restaurant, i.e. the owners' equity. It is equal to share capital plus retained earnings (as reported in the profit and loss account).
Share capital		1 000	
Retained earnings		660	
Total equity		**1660**	

Exam tip !

What's the correct format?

Different firms and different countries use slightly different methods to present their balance sheets. In the IB exams, use the format presented in Table 17.3. Remember to place an appropriate title at the top of the balance sheet.

Exam tip !

The main difference between the balance sheet of incorporated and unincorporated businesses is that share capital does not appear as part of their equity, because the latter do not have shareholders. This is essentially what you need to know and remember for the exams. The vast majority of IB examination questions will ask you to interpret the balance sheet of a limited liability company.

Table 17.3 Format of the balance sheet (for a profit-making business entity)

Statement of financial position for (Company Name) as at (Date)

	$m	$m
Noncurrent assets:		
Property, plant and equipment	500	
Accumulated depreciation	(20)	
Total noncurrent assets		480
Current assets		
Cash	10	
Debtors	12	
Stocks	35	
Total current assets		57
Total assets		342
Current liabilities		
Bank Overdraft	5	
Trade Creditors	15	
Other short-term loans	22	
Total current liabilities		42
Noncurrent liabilities		
Borrowings (long term)	300	
Total noncurrent liabilities		300
Total liabilities		342
Net assets		**195**
Equity		
Share capital*	110	
Accumulated retained profit	85	
Total equity		**195**

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**Note*: for sole traders and partnerships as well as non-profit entities, there is no share capital recorded in the balance sheet.

The balance sheets of sole traders, partnerships and non-profit entities (which are not owned by shareholders) differ slightly to those produced by limited liability companies. For example:

- Sources of finance will differ. Limited companies can raise finance through the sale of shares as well as debentures (recorded under long-term liabilities, as outlined in Chapter 15), whereas this would not appear on the balance sheet of unincorporated businesses.
- Technically, any funds invested by the owners of sole traders and partnerships are recorded as *owners' equity* or *owners' capital* (rather than share capital), as unincorporated firms do not have shareholders.
- Since there are no shareholders in a partnership or sole proprietorship, dividends will not appear under their current liabilities. Instead, the sole trader or partners might take out funds from the business for their personal use (known as drawings to accountants).

Limitations of balance sheets

- As balance sheets are static documents, the financial position of a business might be very different in subsequent periods. For example, the value of capital and reserves can change the next day due to the business using the funds for expansion purposes.
- The figures are, at best, only 'accurate' estimates of the value of assets and liabilities. The *market value* of an asset is not necessarily the same as its *book value* (the value shown on the balance sheet). The true market value of a noncurrent asset is only known once the item has actually been sold. Also, the values shown do not show a detailed breakdown of a firm's assets, so the information is somewhat incomplete.
- Since there is no specific or universal format required for producing a balance sheet, different businesses (or their accountants) will produce accounts in varying formats and include different assets and liabilities. This can make it difficult to compare the financial position of different firms, even those that operate in the same industry.
- Not all assets of a business are included in a balance sheet, especially intangible assets and the value of human capital. For example, professional sports clubs do not include the market value of their players in their balance sheet. To do so would be difficult as each organization would need to determine which players to include in their valuation. Similarly, the club's manager or coach has a market value, but this is not shown on the balance sheet. If the argument that employees are a firm's most valuable assets is actually true, this means that the financial position of a business is not accurately represented in a balance sheet.

Question 17.5 - Marc Brothers Motor Repairs

The financial data for Marc Brothers Motor Repairs (MBMR) are shown below. The company's reporting day for the balance sheet is 31st March of each year.

Property = $630,000, Machinery and vehicles = $230,000, Accumulated depreciation = $144,000, Stock = 30,000, Cash = $12,000, Debtors = $16,000, **Overdraft** = $13,000, Long term bank loan = $380,000, Share capital = $300,000 and Retained earnings = $81,000



(a) Define the term *overdraft*. *[2 marks]*

(b) Outline why cash is important for a business such as Marc Brothers Motor Repairs (MBMR). *[2 marks]*

(c) Use the data above to construct a balance sheet for Marc Brothers Motor Repairs (MBMR). *[6 marks]*

Question 17.6 - Bajaj Electronics

Bajaj Electronics is an importer and exporter of consumer electronic products and computer accessories. Sonali Bajaj, the company's chief financial officer, has presented the following financial data to shareholders at the annual general meeting (AGM). The company reports its **balance sheet** on 31st December each year.

	2022 ($'000)	2021 ($'000)
Bank overdraft	20	10
Cash	25	20
Creditors	50	50
Debtors	70	50
Mortgage	50	50
Noncurrent assets	250	250
Noncurrent liabilities	50	80
Retained earnings	75	75
Share capital	200	150
Stock	100	95

(a) Define the term *balance sheets.* *[2 marks]*

(b) Identify **one** example of noncurrent assets and **one** example of stocks for Bajaj Electronics. *[2 marks]*

(c) Construct a balance sheet for Bajaj Electronics for both years. *[6 marks]*

Question 17.7 - Senjaya Fabrics Ltd.

Hendra Senjaya is the founder of Senjaya Fabrics Ltd., a manufacturer of fabric garments, shoes and handbags in Banten, Indonesia. Hendra has been provided with the following data from the finance department. All figures are in millions of Indonesian rupiah (IDR) as at 31st March of this year.

Cash = IDR32m, Debtors = IDR35m, Mortgage = IDR127m, Overdraft = IDR30m, Property = IDR350m, Retained earnings = IDR100m, **Share capital** = IDR175m, Stocks = IDR60m and Trade creditors = IDR45m.



(a) Define the term *share capital.* *[2 marks]*

(b) Explain **one** reason why stocks (inventories) are important for an organisation such as Senjaya Fabrics Ltd. *[2 marks]*

(c) Using the above data, construct the balance sheet for Senjaya Fabrics Ltd. *[5 marks]*

Theory of Knowledge (TOK)

Is it possible to know if the finances of a company are truly and completely truthful as represented in its final accounts?

Intangible assets

Different types of intangible assets. AO2

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Intangible assets are non-physical fixed assets that have the ability to earn revenue for a business, such as brand names, goodwill, trademarks, copyrights and patents. They are legally protected by laws collectively known as **intellectual property rights**. Intangible assets can account for a large proportion of a firm's asset value, although it is usually difficult to place an objective and accurate price on such assets. The main intangible fixed assets that can appear in a balance sheet include (i) branding, (ii) patents, (iii) copyrights, (iv) goodwill and (v) registered trademarks.

(i) Branding

Brand recognition and brand value (see Chapter 27) help to drive global sales for companies such as Apple and Coca-Cola, year after year. Hence, branding is an indefinite asset as brand recognition and brand loyalty stay with the company for as long as it exists. According to Statista, the Apple brand was worth $264bn in 2021, more than any other global brand that year.



Figure 17.5 - Times Square, New York, where many global brands are instantly recognisable

(ii) Patents

Patents provide legal protection for inventors, preventing others from copying their creation for a fixed number of years. For example, compact discs were patented by Philips, the electronics giant. Patents act as an incentive for firms to innovate. If competitors can simply copy the invention, there would be no need for them to spend large amounts of money on research and development. Patents allow the inventor to have exclusive rights to commercial production for a specified time period. Other firms must apply and pay a fee to the patent holder if they wish to use or copy the ideas, processes or products created by the inventor.

Key concept

Discuss the importance of **creativity** in creating brand value for a business organization of your choice.

(iii) Copyrights

Copyrights© provide legal protection for the original artistic work of the creator, such as an author, photographer, painter or musician. Media sources such as newspapers, sound recordings, computer software and movies are examples of such works. Anyone wishing to reproduce or modify the artist's work must first seek permission from the copyright holder, usually for a fee. The legal copyrights of the contents of this textbook are shared by the author and IBID Press.

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(iv) Goodwill

Goodwill is an intangible asset which exists when the value of a firm exceeds its book value (the value of the firm's net assets). It includes the value of an organization's reputation and corporate image as well as its business connections. A business that treats its workers well is likely to see a lot of goodwill from its workforce, meaning that employees are loyal to the firm and consequently add greater value. Goodwill is then the sum of customer and employee loyalty and can provide a major competitive edge for any business. As US entrepreneur Marshall Field (1834 - 1906) said, "*Goodwill is the one and only asset that competition cannot undersell or destroy*".

However, it can be rather subjective to place a value on goodwill. For example, in early 2022, Boots, the UK's largest health and beauty retailer and pharmacy chain, was put up for sale. Analysts struggled to determine a price tag for the retailer, which ranged from £5 billion (7.1$ bn) and £12bn ($17bn).

(v) Registered trademarks

Registered trademarks™ are distinctive signs that uniquely identify a brand, a product or a business entity. Trademarks can be expressed by names, symbols, phrases or an image, such as the Nike 'swoosh' mark or the four interlocking circles of the Audi logo. Like copyrights and patents, trademarks provide legal protection against those who might try to copy their creations and inventions. As assets, registered trademarks can be sold meaning that ownership can be transferred for appropriate fees and this is reflected in the firm's balance sheet. For example, in 1998 Volkswagen bought the Bentley brand (luxury automobiles) for £430m ($615m).

Note that intangible assets are not always recorded in a balance sheet because their value is very difficult to measure in an objective or scientific way. For example, what are the Google or Coca-Cola brands really worth? How do we value the goodwill of employees in a school or hospital? Does this value depend on whether the organizations are in the private or public sector? No two firms are likely to answer these questions in exactly the same way. The subjective nature of valuing intangible assets renders it unnecessary or even impossible to include on a balance sheet. After all, goodwill is only truly realised when an acquisition or takeover has taken place with the buyer paying a premium for the purchase of the target business. This premium represents the goodwill - the difference between the value of the business and the purchase price.

Therefore, adding the value of intangible assets on a balance sheet can be seen as a form of window dressing to artificially inflate the value of a business. This is perfectly legal, but can distort the underlying financial health of the business. For example, Vodafone managed to turn a €11 billion ($15bn) loss into a €10 billion ($13.7bn) profit in 2006 by the legal use of creative accounting to include goodwill. There is no doubt that intangible assets add value to a business beyond its book value; the uncertainty lies in how to place an accurate value on such assets.

Theory of Knowledge (TOK)

Can the financial data of a business reflect the 'truth' about the organization's corporate culture in any way?

Theory of Knowledge (TOK)

In 2014, Forbes magazine estimated Google's brand value to be around $47bn, whereas Interbrand estimated Google's brand value to be in excess of $93bn. Given this huge difference, is there any substance in the knowledge claims of brand values?

Note that in early 2020, Google became the third American company to be worth $1 trillion based on its market value (after Apple and Microsoft).

ATL Activity 12.1 (Research skills)

Branding consultancy firm Interbrand publishes an annual ranking of the 'Best Global Brands' by market value. Visit their website (www.interbrand.com) to research about the current top 10 global brands and investigate the criteria used by Interbrand to determine the value of these brands.

Question 17.8 - Harry Potter (J.K. Rowling)



J.K. Rowling was unemployed at the time when she wrote her first Harry Potter fantasy novel, back in 1994. In 1998, Warner Bros purchased the rights for film adaptations of the Harry Potter novels. By 2007, Warner Bros and Universal Studios announced the construction of 'Harry Potter World' at the Universal Islands of Adventure theme park in Orlando, Florida in the US.

Prior to the release of Rowling's seventh and final instalment of the series, global sales of her books had already exceeded 400 million copies and been translated into over 65 languages. According to TIME, the Harry Potter brand is worth over $25 billion. The huge commercial success and high market value of the Harry Potter franchise means that Rowling, her publishers and Warner Bros are keen to protect their **intangible assets** including the international copyrights of the Harry Potter books.

(a) Define the term *intangible assets.* *[2 marks]*

(b) In the context of the case study, explain **two** benefits of protecting copyrights. *[4 marks]*

(c) Comment on how the $25 billion valuation of the Harry Potter brand might be affected by the subjective nature of placing values on intangible assets. *[4 marks]*

Limitations of final accounts

- Using a single year's accounts in isolation is of little value as this does not allow analysts to judge the financial performance of the business over time. Instead, a series of final accounts would be more useful to determine any trends in the data.
- Human resources are totally ignored when examining final accounts. The skills, loyalty, goodwill and motivation of employees are all overlooked in financial analyses. The inability to retain or motivate staff, for example, can have major repercussions on the future financial position of the business.
- Final accounts do not reveal anything about the firm's non-financial matters or priorities, such as its organizational culture and contributions to local communities. Qualitative factors can be equally important in business decision-making. For example, ethical objectives and the location of industry (see Chapter 38) are affected by both financial and non-financial factors.
- There also needs to be access to the final accounts of other businesses in order to benchmark the financial performance with competitors in the industry. Therefore, this can be rather time consuming.
- Whilst final accounts must be lawfully produced, this does not mean that they reveal the whole truth. Companies will limit, within reason, the financial information that they disclose because their final accounts will be in the public domain and hence accessible by their competitors.
- The final accounts are historical accounts of the financial position of a business at one point in time. Past financial performance is not necessarily indicative of current or future performance or success.

Theory of Knowledge (TOK)

Scottish author Thomas Carlyle, (1795 - 1881) said that *"You may prove anything by figures"*. To what extent does this claim apply to knowledge in Business Management?

HIGHER LEVEL

Depreciation (Higher Level only)

Depreciation using the following methods: (i) straight line method and (ii) units of production method. AO2, AO4

Appropriateness of each depreciation method. AO3

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Property and land tend to rise in value over time. The increase in the value of noncurrent assets is known as **appreciation.** However, most noncurrent assets tend to depreciate over time. **Depreciation** is the fall in the value of noncurrent (or fixed) assets over time. This fall in value is due to:

- **Wear and tear** - Fixed assets such as computers and motor vehicles are used repeatedly over time, so they tend to wear out and raise maintenance costs. Hence, there is a fall in the value of these noncurrent assets over time.
- **Obsolescence** - As newer and better products become available, the demand and hence the value of existing noncurrent assets will fall. Obsolete assets are out-of-date assets, such as older versions of vehicles, computers, equipment, smartphones or software.



Figure 17.6 - Depreciation is the fall in the value of an asset over time

Depreciation spreads the **historic cost** (purchase cost) of fixed assets over their useful lifespan. The change in the value of noncurrent assets is shown by reassessing their value on a balance sheet (under the heading of "accumulated depreciation"). Depreciation needs to be recorded in order to:

- Calculate the value of a business more accurately - Depreciating noncurrent assets will reduce the value of net assets to better reflect the true value or financial position of a business. Similarly, revaluing noncurrent assets that have appreciated will increase the net asset value.
- Realistically assess the value of noncurrent assets over time - The historic costs of fixed assets, such as machinery and vehicles, are unlikely to be equal to their current market value.
- Plan for the replacement of assets in the future - Provisions are made for purchasing new noncurrent assets. Note that depreciation is also recorded on the P&L account as an expense because it reflects the fall in the value of noncurrent assets that will eventually need to be replaced.

There are two methods of calculating depreciation specified in the IB syllabus: (i) the straight line method and (ii) the units of production method. In practice, it does not really matter which method is used but in order to allow for meaningful and historical comparisons, it is vital for a business to be consistent in its choice of method used.

(i) Straight line method

The **straight line method** of calculating depreciation reduces the value of a noncurrent asset by the same value each year throughout its useful life. This is the relatively easier of the two methods used to calculate depreciation of fixed assets, so is the most commonly used method. The annual depreciation is calculated using three key variables:

- The *life expectancy* of the noncurrent asset - how long it is intended to be used before it needs to be replaced
- The *scrap value* (or *residual value*) of the noncurrent asset - how much it is expected to be worth at the end of its useful life and
- The *historic cost* - the purchase cost of the noncurrent asset.

To calculate depreciation using the straight line method, the following formula is used:

$$\text{Annual depreciation} = \frac{\text{Purchase cost}}{\text{Lifespan}}$$

For example, if an electronic security system is bought for $25,000 and is expected to last 5 years (when it will be replaced), the annual depreciation is a fixed amount of $5,000 (i.e. $25,000 ÷ 5 years). The value of the asset at the end of each year is shown in Table 17.4 and represented diagrammatically in Figure 17.7.

Table 17.4 - Straight line depreciation at $5,000 per annum

Year end	Depreciation ($)	Book value ($)	Accumulated depreciation ($)
0	-	25,000	
1	5,000	20,000	5.000
2	5,000	15,000	10,000
3	5,000	10,000	15,000
4	5,000	5,000	20,000
5	5,000	0	25,000

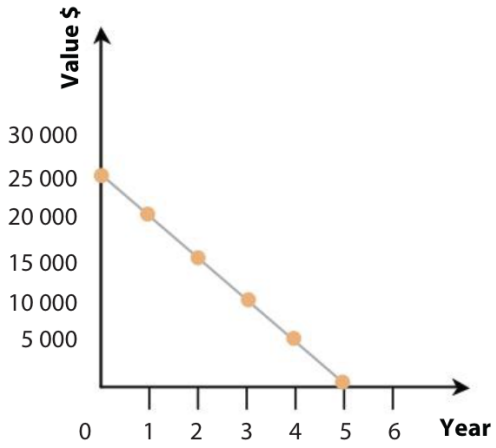

Figure 17.7 - Straight line depreciation

The **residual value** (or **scrap value**) is an estimate of the value of the noncurrent asset at the end of its useful life. Many firms simply use a zero residual value as estimates may prove to be highly inaccurate. However, it is unusual for some fixed assets to lose all of their value because they can fetch a minimal price when sold. In such a case, the formula becomes:

$$\text{Annual depreciation} = \frac{\text{Purchase cost } \textit{minus} \text{ Residual value}}{\text{Lifespan}}$$

So, if the electronic security system is expected to fetch a second-hand value of $5,000 in 5 years' time, then the annual amount of depreciation is worked out as ($25,000 – $5,000) ÷ 5 years = $4,000 per annum. Hence, in this case, there is a difference of $1,000 each year compared with the depreciation charge if there is no residual value.

The key advantage of the straight line method is that it is simple to calculate and to understand. However, the main weakness is that depreciating noncurrent assets by an equal amount each year is not generally realistic. For example, motor vehicles lose a much larger percentage of their value at the beginning of their useful life cycle. Furthermore, the straight line depreciation method does not account for the loss of efficiency or the higher repair costs of noncurrent assets over time.

Question 17.9 - Safarie Air Tours

Safarie Air Tours is owned by Achmad Safarie. The company recently paid $5.2 million for a second-hand airplane. The **noncurrent asset** has an estimated useful life of 5 years, with an expected **residual value** of $1.6m.



(a) Define the term *noncurrent asset*. *[2 marks]*

(b) Define the term *residual value*. *[2 marks]*

(c) Calculate the value of the annual depreciation for Safarie Air Tours. *[2 marks]*

HIGHER LEVEL

Finance and accounts

(ii) Units of production method

The **units of production** method of calculating depreciation allocates an equal amount of depreciation to each unit of output rendered by a noncurrent asset. It calculates depreciation based on physical output, so is applicable for calculating the fall in value of assets based on their usage rather than time. For example, vehicles depreciate with more miles of usage. The same applies to the use of a photocopier, printers or any other type of machinery.

To calculate the depreciation using the units of production method (also referred to as the **units of output method**), two steps are required:

- Calculate the depreciation per unit by using the formula:

$$\textbf{Depreciation per unit} = \frac{\textbf{Purchase cost minus Scrap value}}{\textbf{Expected number of units over lifetime}}$$

- Calculate the depreciation expense for each time period by using the formula:

$$\textbf{Depreciation expense} = \textbf{Depreciation per unit} \times \textbf{Number of units produced}$$

Essentially, the depreciation charge per unit of output is multiplied by the number of units of goods or services produced during the accounting period to find the period's depreciation expense. For example, suppose that a business bought a printing machine for $500,000 and expects it to last for 5,000 hours for a 5-year period before it needs to be replaced and sold for a scrap value of $100,000. Using the above formulae, the depreciation using the units of production method is calculated as:

Depreciation per unit = ($500,000 – $100,000) / 5,000 hours = $80 per hour.

Now, suppose the business uses the printing machine for 1,500 hours in the first year. The depreciation expense is then:

Depreciation expense = $80 × 1,500 hours = $120,000.

Therefore, the reduction in the value of the noncurrent asset is reflected by a negative amount shown as accumulated depreciation in the balance sheet.



Figure 17.8 - Machinery depreciates over time due to usage

Question 17.10 - Neville Stibbs Printers

Neville Stibbs Printers (NSP) purchased a new printing machine for $250,000. It is estimated to produce 500,000 units of output over the next four year, when it is expected to be sold for $50,000. NSP uses the units of production method for calculating depreciation. The expected units of output from the machine for the first two years are shown below.

Year	Output (units)
1	90,000
2	110,000

(a) Describe the *units of production* method of calculating depreciation *[2 marks]*

(b) Calculate the depreciation per unit of production for NSP. *[2 marks]*

(c) Calculate the depreciation expense for Year 1 NSP. *[2 marks]*

(d) Calculate the book value of the printing machine at the end of Year 2. *[2 marks]*

The units of production method of calculating depreciation is more cumbersome to calculate than the straight line method. As shown in Question 17.10 there is a need to calculate the depreciation for each time period based on the asset's usage rate and then to adjust the calculation from one period to the next. However, the added effort of using the units of production method gives businesses better insights into the true running cost of the noncurrent asset, such as machinery and other capital equipment. This, in turn, can help businesses to determine how quickly they are likely to fully deplete the value of the noncurrent asset.

Final accounts and the key concepts

Final accounts can provide invaluable data for strategic planning and change management. The financial documents of a business are important for two key reasons: *disclosure* and *accountability* of financial matters of a business. Used properly and ethically, they can reveal the financial health and profitability of a business. If profit has been declared due to a one-off sale of noncurrent assets, such as land or property, then there is likely to be low profitability. Although window dressing is not illegal per se, there may be questions about the ethical nature of such practices.

As part of a firm's business strategy, managers will examine the liquidity position of the organization (see Chapter 20). The balance sheet reveals the ability of the firm to meet its daily running costs. Indeed, both the balance sheet and P&L accounts are often used by businesses seeking to secure external funding for growth and expansion (see Chapter 6) to ensure the sustainability of the business.

A common strategy to achieve this is to develop the firm's intellectual property rights (IPR). The use of IPRs such as patents and copyrights can act as an effective form of barrier to entry. Global businesses such as Coca-Cola, Toyota and The Walt Disney Company use IPRs to create barriers to entry thereby protecting their market share in a more sustainable way. Aristotle Onassis (1906 - 1975), a Greek business mogul, said that the secret to corporate success is to have or know something that no one else does. This means that creativity and new product development (see Chapter 42) are important strategies for long term survival. The legal protection of IPRs for new products, designs and processes can therefore increase the firm's value on its balance sheet. In today's ever-more competitive and fast-changing environment, many organizations no longer see IPRs as a defensive strategy, but as an offensive business strategy for corporate success.

However, one ongoing issue is that different countries have different laws and cultural norms regarding the construction of the final accounts. However, the consensus in modern societies is that all business decisions, including the reporting of financial accounts, have ethical implications for their various stakeholder groups in accordance with the principles and ethics of accounting practice in the country. Ethical behaviour is about doing what is perceived to be the right thing to do,

from society's point of view. Wrongdoings, even if not illegal, are unethical. For example, there are professional regulatory bodies set up to monitor ethical standards and practices in the accountancy industry. Examples include the Australian Accounting Standards Board, Accounting Standards Committee of Germany and America's Financial Accounting Standards Board. Accountants need to be open, transparent and honest in the recording and reporting of all financial transactions. This means the final accounts of an organization should be produced accurately and truthfully, meeting the needs of the relevant tax authorities. Hence, most businesses will have an annual audit of their financial accounts, to ensure that their accounting practices are completed with integrity, objectively and ethically.

Theory of Knowledge (TOK)

Can creativity in financial reporting ever be disregarded as being unethical?

Key concept

With reference to an organization of your choice, discuss how **change** has affected its final accounts (the balance sheet and/or the profit and loss account).

Key concept

With reference to intellectual property rights (IPRs) as noncurrent assets, discuss the importance of **creativity** for business success.

Business Management Toolkit

Discuss why product portfolio management directly impacts a firm's final accounts. You might find it useful to refer to Chapter 47 (the Boston Consulting Group matrix) before answering this question.

Exam tip !

As with all quantitative techniques, it is vital to look beyond the financial data. Final accounts are just one part of the quantitative analyses required to give an accurate appraisal of a firm's financial position. For example, budgeting is an important consideration for the daily operation of a business, whilst investment appraisal assesses the potential financial gains on growth and expansion plans. You should also consider qualitative issues, such as organizational objectives, the state of the economy and corporate culture. So, the importance of any single financial statement (such as balance sheets or profit and loss accounts) should be handled with some caution.

REVIEW QUESTIONS

1. With reference to different stakeholder groups, what is the purpose of final accounts?
2. What are the two sets of final accounts that all companies are obliged to report to their shareholders or owners?
3. What is a profit and loss account?
4. What is a balance sheet?
5. What is gross profit?
6. What is meant by cost of goods sold (or cost of sales)?
7. How do costs differ from expenses when reported on a profit or loss account?
8. How are the profits of a limited liability company appropriated (after interest and taxes have already been paid)?
9. For a non-profit entity, what is meant by retained surplus?
10. What is window dressing?
11. What is a balance sheet?
12. How do assets differ from liabilities?

13. How do noncurrent assets differ from current assets?

14. How are assets calculated?

15. In the context of balance sheets, what is meant by equity?

16. What is share capital?

17. What are retained earnings?

18. What are the limitations of using balance sheets?

19. What are intangible assets?

20. What is meant by depreciation?

21. What is meant by the residual or scrap value of a noncurrent asset?

22. How does the straight line method of depreciation reduce the value of noncurrent assets?

23. How does the units of production method of depreciation reduce the value of noncurrent assets?

24. What are the relative merits of the two methods used to depreciate fixed assets?

25. What are the limitations of the final accounts?

KEY TERMS

A **balance sheet** contains financial information about an organization's assets, liabilities and the capital invested by the owners, showing a snapshot of the firm's financial situation.

Book value is the value of an asset as shown on a balance sheet. The market value of assets can be higher than its book value because of intangible assets such as the brand value or goodwill.

Cost of goods sold (COGS), also known as **cost of sales** (COS) refers to the direct costs of producing or purchasing stock that has been sold to customers.

Creditors are suppliers who allow a business to purchase goods and/or services on trade credit.

A **current asset** refers to cash or any other liquid asset that is likely to be turned into cash within 12 months of the balance sheet date. Examples include cash, debtors and stocks.

Current liabilities are debts that must be settled within one year of the balance sheet date. Examples include bank overdrafts, trade creditors and other short-term loans.

Depreciation is the fall in the value of noncurrent assets over time, caused by wear and tear (due to the asset being used) or obsolescence (out-dated).

Expenses are the indirect or fixed costs of production, such as administration charges, management salaries, insurance premiums and rent.

Final accounts are the published annual financial statements that all limited liability companies are legally obliged to report, namely the balance sheet and the P&L account.

Goodwill is an intangible asset which exists when the value of a firm exceeds its book value (the value of the firm's net assets).

Gross profit is the difference between the sales revenue of a business and its direct costs incurred in making or purchasing the products that have been sold to its customers.

The **historic cost** refers to the purchase cost of a particular fixed asset. It is used in the calculation of depreciation.

Intangible assets are noncurrent assets that do not exist in a physical form but are of monetary value, such as goodwill, copyrights, brand names and registered trademarks.

Net assets show the value of a business to its owners by calculating the value of all its assets minus its liabilities. This figure must match the equity of the business in the balance sheet.

Noncurrent assets are items owned by a business, not intended for sale within the next twelve months, but used repeatedly to generate revenue for the organization, such as property, plant and equipment.

Noncurrent liabilities are the debts owed by a business, which are expected to take longer than a year from the balance sheet date to repay.

Profit is the surplus (if any) that a business earns after all expenses have been paid for from the firm's gross profit.

The **profit and loss account** is a financial record of a firm's trading activities over the past 12 months, showing all revenues as well as costs and revenues during this time.

The **residual value** (or **scrap value**) is an estimate of the value of the noncurrent asset at the end of its useful life.

Retained profit is the amount of profit after interest, tax and dividends have been paid. It is then reinvested in the business for its own use.

Share capital refers to the amount of money raised through the sale of shares. It shows the value raised when the shares were first sold, rather than their current market value.

Straight line method is a means of calculating depreciation that reduces the value of a fixed asset by the same value each year throughout its useful life.

The **units of production method** of calculating depreciation allocates an equal amount of depreciation to each unit of output rendered by a noncurrent asset.

Window dressing refers to the legal act of creative accounting by manipulating financial data to make the results appear more appealing.



Figure 17.9 - Fixed assets can have a scrap value

Chapter 18

Unit 3.5 - Profitability and liquidity ratio analysis

"Many of the things you can count, don't count. Many of the things you can't count, really count."
- Albert Einstein (1879 - 1955), Mathematics genius

Contents

3.5 Profitability and liquidity ratio analysis	
SL/HL content	**Depth of teaching**
The following profitability ratios: • Gross profit margin • Profit margin • Return on capital employed (ROCE)	AO2, AO4
Possible strategies to improve these ratios	AO3
The following liquidity ratios: • Current ratio • Acid-test (quick) ratio	AO2, AO4
Possible strategies to improve these ratios	AO3

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CORE

Ratio analysis

In its simplest sense, a ratio is one number expressed in terms of another. For example, in an organization with 20 men and 30 women, the male to female ratio is 2:3, i.e., for every two male workers, there are 3 female workers. **Ratio analysis** is a quantitative management tool that compares different financial figures to examine and judge the financial performance of a business. It requires the application of figures found in the final accounts, namely the balance sheet and the profit and loss account (see Chapter 17). To assess whether financial performance has improved, ratios for the current period are compared with historical figures. In addition, the same ratios can be compared to those of rival businesses to judge whether the firm has improved against its competitors.

Exam tip !

Don't just simply learn the formulae for the ratios without understanding what they actually mean. Instead, focus on *why* or *how* the ratios could be used in the context of the given organization. You should address issues such as:

- How is the business performing (based on the given financial data)?
- How has the business performed over time (trends)?
- What else needs to be considered that is not presented in the data? For example, think about business objectives and external constraints on the organization's performance.

The purpose of ratio analysis

- To examine a firm's financial position, such as its profitability as well as short- and long-term liquidity position.
- To assess a firm's financial performance, such as its ability to control expenses.
- To compare actual figures with projected or budgeted figures (known as variance analysis) in order to improve financial management.
- To aid decision-making, such as whether investors should risk their money by investing in the business.

Ratios are compared in two ways:

- *Historical comparisons* involve comparing the same ratio in two different time periods for the same business. Such comparisons show trends, thereby helping managers and decision makers to assess the financial performance of the business over time.
- *Inter-firm comparisons* involve comparing the same ratios of businesses in the same industry. For example, two businesses might have the same amount of profit although their sales revenue may be quite different. Ratio analysis can therefore show the relative financial performance of businesses competing in the same market.

In reality, businesses use both historical and inter-firm comparisons when analysing their financial ratios. However, it is important to remember that ratio analysis is only of value if managers compare *like with like*. For example, McDonald's should only compare its financial ratios with rivals of similar size in the same industry. There is little, if any, value in McDonald's comparing its financial ratios against a sole trader who runs a single fast food restaurant or comparing its figures to manufacturers of furniture.



Figure 18.1 - Financial ratio analysis helps firms to determine their return on investments

Exam tip !

When learning the different financial ratios in the syllabus, make sure that you understand the various *units of measurement* used. Some ratios are expressed as a number in terms of another (e.g. 2:1), whilst others are shown as a percentage or even as 'number of days'. The important thing is to understand the meaning of the ratio and to be able to write about the ratio in the context of the organization.

Profitability ratios

The following profitability ratios: (i) gross profit margin, (ii) profit margin and (iii) Return on capital employed (ROCE). AO2, AO4
Possible strategies to improve these ratios. AO3
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Profitability ratios examine profit in relation to other figures, such as the ratio of profit to sales revenue. These ratios tend to be relevant to for-profit businesses (such as large multinational conglomerates) rather than for non- -profit organizations (such as charities). Managers, employees and potential investors may be interested in profitability ratios as they show how well the firm has performed in financial terms.

For example, the two firms in Table 19.1 generate the same amount of absolute profit but Firm A is more profitable. This is because it generates $100m profit from using capital worth $200m (a return of 50%), whereas Firm B earns the same amount profit from using $250m worth of capital resources (a smaller return of 40%).

Table 19.1 - Efficiency and the use of capital resources

	Firm A	Firm B
Profit	$100m	$100m
Capital employed	$200m	$250m
Profitability ratio	50%	40%

Profit is a key objective for most businesses and acts as a measure of a firm's financial success. **Profit** is defined as the financial surplus earnings of an organization once all costs have been deducted from sales revenue. Profitability ratios measure profit in relation to other variables such as sales turnover or capital employed. The main profitability ratios are the gross profit margin (GPM), profit margin and return on capital employed (ROCE).

The absolute amount of profit, as declared in a profit and loss account (see Chapter 17), tells us little about the financial performance of a business. For example, is a business financially successful if it earns $10 million profit? The answer might be 'yes' for a small partnership selling computer accessories, but the answer would be a definite 'no' for a much larger business such as Lenovo or IBM. We can draw this conclusion when comparing the ratio of profit to the huge sales turnover of or the amount invested by, Lenovo and IBM. Hence, to assess the profitability of a business, it is necessary to compare and relate profit to other financial aspects of the business. A key limitation of using profitability ratios is that they only apply to profit-orientated businesses.

Exam tip!

When dealing with finance, it is important to look at the bigger picture and to put the figures into context. For example, in February 2007, sportswear manufacturer Puma announced a 26% drop in profits to €38.2 million ($43m). Does this represent poor performance? Not necessarily. This very limited information can, on its own, be misleading. In fact, Puma was undergoing expansion and was using its retained profits to finance its growth (hence the fall in its declared profits). Puma's sales had actually increased by more than 33%. Ten years later, Puma declared profit of €135.2 million. By the end of 2020, the company had profits of more than €262 million and total equity of $2 billion.

(i) Gross profit margin (GPM)

The **gross profit margin** shows the value of a firm's gross profit expressed as a percentage of its sales revenue. The figures for working out the GPM are found in the profit and loss account, using the formula:

$$\text{GPM} = \frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$$

The GPM ratio is expressed as a percentage figure. For example, if a business has a gross profit of $120 million from sales of $200 million, then the GPM is 60%. This means that for every $100 of sales revenue, $60 is gross profit (with costs of goods sold accounting for the other $40). The higher the GPM, the better it is for a business as gross profit goes towards paying its expenses. The GPM ratio can be improved in two main ways:

Raising sales revenue

- Reducing the selling price of products for which there are many substitute products - This enables the firm to gain a competitive advantage by having lower prices for products that are price elastic (see Chapter 28).
- Raising the selling price of products for which there are few if any substitutes - If customers are not very responsive to changes in price (due to strong brand loyalty or a lack of close substitute products), then the business can gain higher sales revenue by charging a higher price for these price inelastic goods and services.
- Using improved marketing strategies to raise sales revenue - For example, special promotions (see Chapter 29) and product extension strategies (see Chapter 27) can help to increase sales.
- Seeking alternative revenue streams (see Chapter 16) - This can enable the business to improve its sales revenue, particularly when it is affected by fluctuations in seasonal demand or intense rivalry in the market.



Figure 18.2 - Beach holiday resorts are prone to seasonal fluctuations in demand

Reducing direct costs

- Cutting direct material costs - For example, businesses might choose to use cheaper suppliers and/or cheaper materials. Some airlines have saved millions of dollars each year by cutting back on the amount of chocolates or snacks that they offer on-board. However, cost cutting can have a negative impact on the perceived quality of the good or service.

- Cutting direct labour costs - Businesses might choose to reduce staffing costs by reducing the number of staff, flexitime (see Chapter 10) or using non-financial incentives to get employees to do more work. In any case, labour productivity may increase, thereby reducing unit labour costs. However, this method can cause resentment and demotivation in the workforce.

In reality, a business is likely to strive to raise its GPM ratio by a combination of methods to reduce costs and to raise revenues.

(ii) Profit margin

The **profit margin** shows the percentage of sales turnover that is turned into overall profit. A profit margin ratio of 35% means that for every $100 of sales, $35 is profit. This is the amount of profit that is left after all production costs are accounted for (both direct and indirect costs). The ratio is calculated using the formula:

$$\text{Profit margin} = \frac{\text{Profit before interest and tax}}{\text{Sales revenue}} \times 100$$

Note: It is important to use profit *before* interest and tax to calculate the profit margin ratio because this allows for historical comparisons to be made. Profits are subject to change over time, caused by fluctuating interest rates and tax rates (both of which are beyond the control of a business so would distort the underlying financial performance of the business).

The profit margin ratio is a better measure of a firm's profitability than the GPM ratio as it accounts for both cost of sales (direct costs) and expenses (indirect costs). The difference between a firm's GPM and its profit margin represents the expenses and therefore the larger the difference between these two ratios, the more difficult overhead control tends to be. As with the GPM, the general rule is that the higher the profit margin ratio, the better it is for the organization.

It is common for high volume products, such as confectionary and fast food, to have a relatively low profit margin. However, the high sales volume compensates for this. Conversely, for low volume products, such as aircraft and luxury watches, the profit margin is high to compensate for the lower volume of sales.

The profit margin ratio can be improved by financial and non-financial strategies such as those mentioned above for the GPM.

However, costs can be examined further to reduce business expenses. For example, it may be possible to:

- Discuss preferential payment terms with trade creditors and suppliers - By delaying payment, a business may be able to improve its cash flow management (see Chapter 20). Alternatively, it might be possible to negotiate discounts for paying creditors on time.

- Negotiate cheaper rent - Trustworthy and creditable businesses may be able to negotiate lower rents to reduce expenses or delay payment of rent to improve their cash flow position.

- Reduce indirect costs - Careful examination of an organization's expenses might reveal areas where costs can be cut without detrimental effects to the business. For example, many businesses no longer pay senior executives to fly first class, choosing business class or premium economy class travel instead. Other overheads that might be reduced include advertising, stationery and insurance premiums.



Figure 18.3 - Executive air travel is an expensive cost for firms

To calculate financial ratios, such as the GPM and the profit margin, it is usually necessary to use a **balance sheet** and a **profit and loss account** (see Chapter 17). For illustrative purposes, the numerical questions that follow in Chapters 18 and 19 will refer to the numbers given in Tables 18.1 and 18.2 for JKL Ltd., a fictitious company.

Table 18.1 - Statement of financial position for JKL Ltd. as at 31st December (figures in $'000s)

	Year 2	Year 1
Noncurrent assets	600	500
Current assets		
Cash	200	50
Debtors	150	200
Stock	350	250
Total assets	700	500
Current liabilities	1300	1000
Total assets less current liabilities	1 000	800
Noncurrent liabilities	250	250
Total liabilities	550	450
Net assets	**750**	**550**
Share capital	500	500
Retained earnings	250	50
Equity	**750**	**550**

Table 18.2 - Excerpts from JKL Ltd.'s statement of profit or loss for years ended 31st December ($'000s)

	Year 2	Year 1
Sales revenue	1 000	850
Cost of goods sold	500	350
Profit before interest and tax	400	360
Tax	100	90
Dividend	50	220
Retained profit	250	50

Question 18.1

(a) Determine the value of JKL Ltd.'s gross profit and its expenses in both years. *[2 marks]*

(b) Calculate the GPM and the profit margin ratios for JKL Ltd. in both years (show all your working). *[4 marks]*

(c) Explain your findings from the previous question. *[4 marks]*

(d) Comment on further information that could be used to determine the profitability of JKL Ltd. *[4 marks]*

Exam tip !

Although a price reduction can reduce the gross profit margin (GPM), it is possible this can improve the profit margin ratio. A numerical example is provided below.

	Before ($)	After ($)	
Sales turnover	1,000	1,200	
Cost of goods sold	600	740	
Gross profit	400	460	
GPM	40.0%	38.3%	↓
Indirect costs	300	300	
Profit	100	160	
Profit Margin	10.0%	13.3%	↑

The fall in price will automatically reduce the profit margin, other things being equal. However, the price reduction has attracted more customers and since indirect costs are constant, the NPM has increased.

(iii) Return on capital employed (ROCE)

The **return on capital employed (ROCE)** is a profitability ratio that measures the financial performance of a firm based on the amount of capital invested. It is calculated by using the formula:

$$\text{ROCE} = \frac{\text{Profit before interest and tax}}{\text{Capital employed}} \times 100$$

The figure for capital employed can be seen on a firm's balance sheet (see Chapter 17). Capital employed is the sum of owners' equity plus noncurrent liabilities, i.e. it is the sum of total internal sources of finance plus all long term external sources of finance.

Capital employed = Noncurrent liabilities + Equity

Recall that loan capital is shown as noncurrent liabilities on the balance sheet (see Chapter 17). The ROCE ratio shows profit as a percentage of the capital used to generate it. The higher the ROCE figure, the better it is for the business. A 20% ROCE figure shows that for every $100 invested in the business, $20 profit is generated. As a general rule, the ROCE should at least exceed the interest rate offered at commercial banks; otherwise, it would be better to simply deposit the capital in an interest-bearing bank account. In addition, bank deposits would probably carry less risk compared with other investment projects. Hence, the ROCE must be high enough to create an incentive for investors to part with their money.



Figure 18.4 - A ROCE of 20% means €200 is earned per €1,000 invested

Note: ROCE is calculated by using profit before tax and interest as this allows for better historical comparisons (since interest and tax rates are subject to change over time and are beyond the control of the business). Many people regard the ROCE as the single most important financial ratio as it measures how well a firm is able to generate profit from its sources of funds. Hence, the ROCE is sometimes referred to as the **key ratio.**

The ROCE ratio can be improved mainly by strategies to boost a firm's profits (see above). Mathematically, the ROCE ratio will also increase if capital employed falls whilst net profits remain constant, although in reality this is probably not desirable.

Question 18.2

(a) Calculate the ROCE ratio for JKL Ltd. for both years. *[3 marks]*

(b) Explain what the figures suggest about the efficiency and profitability of JKL Ltd. *[4 marks]*

Question 18.3 - Dan & Glover Co.

Dan & Glover has a **gross profit** of $150m, expenses of $30m and capital employed of $400m.

(a) Define the term *gross profit.* *[2 marks]*

(b) Calculate Dan & Glover's return on capital employed (ROCE). *[2 marks]*

Liquidity ratios

The following liquidity ratios: (i) current ratio and (ii) acid test (quick) ratio. AO2, A04.
Possible strategies to improve these ratios. AO3
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Liquidity ratios look at the ability of a firm to pay its short-term liabilities, such as by comparing its net cash flow to its short-term debts. Creditors and financial lenders are interested in liquidity ratios to help assess the likelihood of getting back the money they are owed. Shareholders and potential investors may also be interested as these ratios can reveal a firm's ability to repay its debts.

Certain assets of a business can be turned into cash quickly, without losing their value. These assets are known as **liquid assets** and can be in the form of cash itself, stocks (finished goods, ready for sale) and debtors (see Chapter 17). Liquidity ratios calculate how easily an organization can pay its short-term financial obligations from its current assets. The two main liquidity ratios are the current ratio and the acid test ratio.

(i) Current ratio

The current ratio deals with a firm's liquid assets and current liabilities. It reveals whether a firm is able to use its liquid assets to cover its short-term debts within the next twelve months of the balance sheet date. The current ratio is calculated by using the formula:

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

For example, if a business has current assets (cash, debtors and stocks) valued at $300,000 and current liabilities (such as overdrafts and trade creditors) of $120,000, then the current ratio would be 300,000 / 120,000 = 2.5. This means the firm has $2.50 of current (liquid) assets for every $1 of current liabilities.

It is generally accepted that a current ratio of between 1.5 to 2.0 is desirable. This allows for a safety net because in reality it might not be possible to sell current assets quickly without losing some value. It also means that there is likely to be sufficient **working capital** (the numerical difference between current assets and current liabilities). If a business has substantial positive working capital, then it has the potential to invest and grow. By contrast, if its current assets are lower than its current liabilities (negative working capital), then the business may have problems paying back trade creditors and suppliers. In the worst-case scenario, negative working capital can lead a firm to go bankrupt.

Therefore, a current ratio of less than 1.0 means the short-term debts of the business are greater than its liquid assets, which could jeopardise its survival if creditors demand payment.

Equally though, a firm can have too high of a current ratio. This suggests that any combination of three outcomes:

- There is too much cash in the business, which could be better spent to generate more trade
- There are too many debtors, which increases the likelihood of bad debts or customers defaulting on the money they owe
- There is too much stock, which increases storage and insurance costs.

As always, it is important to put ratios into context. For example, supermarkets hold a huge amount of stock so may have a current ratio of over 2:1 but this is acceptable as their stocks are highly liquid.

The current ratio can be improved by a combination of raising the value of current assets and reducing the value of current liabilities. For example, overdrafts can be reduced by opting for long term loans that offer more attractive rates of interest. This will also free up working capital in the short term. However, this option may, of course, affect the long term liquidity of the firm.

(ii) Acid test ratio (Quick ratio)

The **acid test ratio** (or the **quick ratio**) is similar to the current ratio except it ignores the value of stock when measuring the short-term liquidity position of a business. The formula for working this out is:

$$\frac{\text{Current assets} - \text{Stock}}{\text{Current liabilities}}$$

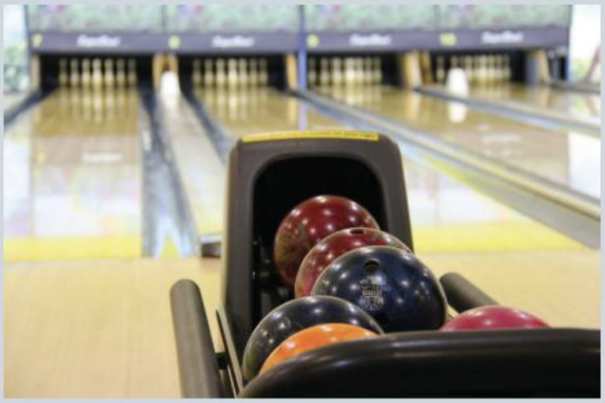
This approach can be more meaningful than the current ratio because stocks are not always easily converted into cash, i.e. not all stocks are highly liquid. For example, work-in-progress (semi-finished) goods do not have much value added, so would not fetch a very good price. Also, highly expensive stock, such as Boeing aircraft, cannot be turned into cash quickly.

As a general guideline, the quick ratio should be at least 1:1 otherwise the firm might experience working capital difficulties or even a **liquidity crisis** (a situation where a firm is unable to pay its short-term debts). As with the current ratio, too high an acid test figure can suggest that the firm is holding onto too much cash rather than using it more effectively. As always, however, this ratio must be put into the context of the business and the industry in which it operates.

Question 18.4 - Bjorn Bowls

Bjorn Perera owns and operates a bowling centre called Bjorn Bowls. The company has reported the following financial data:

- Cash = $50,000
- **Debtors** = $35,000
- Overdrafts = $15,000
- Stocks = $45,000
- Tax = $25,000
- Trade creditors = $50,000



(a) Define the term *debtors*. *[2 marks]*

(b) Calculate the current ratio for Bjorn Bowls. *[2 marks]*

(c) Comment on your findings in the previous question. *[2 marks]*

Potential investors and short-term lenders are likely to be interested in a firm's acid test ratio. Since the ratio measures the ability of a firm to cover short-term debts with its cash and debtors, this will help reduce the exposure of risk to investors and financial lenders such as commercial banks.

Mathematically, the quick ratio can be improved by either raising the level of current assets (cash or debtors) or lowering the amount of current liabilities. It can be risky for a firm to increase debtors since this increases the likelihood of bad debts occurring. There is also a potentially large opportunity cost in holding too much cash. Hence, it is more practical for a business to concentrate on reducing its short-term liabilities, such as overdrafts and trade creditors. For example, it might be possible to negotiate delayed payments to trade creditors.

Uses and limitations of ratio analysis

Ratio analysis provides useful data for the various stakeholder groups of a business (see Chapter 4) who have a direct interest in its financial performance. Essentially, stakeholders use financial ratios to aid decision-making by assessing the relative financial strengths and weaknesses of the business. For example:

- Employees and trade unions can use financial ratios to assess the likelihood of pay rises and the level of job security (possibly revealed by profitability and liquidity ratios).
- Managers and directors can assess the likelihood of getting management bonuses for reaching profitability, liquidity and efficiency targets. They can also use financial ratios to identify areas that need improving.
- Trade creditors look at short term liquidity ratios to ensure that their customers (i.e. other businesses) have sufficient working capital to repay them.
- Shareholders use financial ratios to assess the return of their investment compared to other investments, such as holding shares in other companies or savings in a commercial bank account.
- Financiers use ratios to consider if the business has sufficient funds and profitability to repay any loans that may be approved.
- The local community can use a range of financial ratios to gauge job opportunities for local residents. They might also use ratios to secure sponsorship deals for local community projects.

However, financial ratio analysis does have its limitations:

- Ratios are a historical account of an organization's performance. They do not indicate the current or future financial situation of a business, although they can give an indication of the financial health of the firm.
- Changes in the external business environment (see Chapter 46) can cause a change in the financial ratios without there being any underlying change in the performance of a business. For example, higher tax rates will reduce profitability, although sales revenues may have actually increased.
- There is no universal way to report final accounts so this means that businesses may use slightly different accounting procedures and policies. This makes inter-firm comparisons more difficult. For example, some firms use the straight-line method for depreciating noncurrent assets whilst others use the units of production method (see Chapter 17).

Question 18.5

(a) Refer to the accounts for JKL Ltd. shown in Tables 18.1 and 18.2 to calculate the current ratio and the acid test ratio for both years. *[4 marks]*

(b) Based on your findings to the above question, comment on the liquidity position of JKL Ltd. *[4 marks]*

(c) Explain what other information might be needed to judge the liquidity position of JKL Ltd. *[4 marks]*

- Qualitative factors that affect the performance of an organization are totally ignored. For example, the level of staff motivation and customer perceptions of quality are not considered in financial ratio analysis.

- Organizational objectives differ between businesses, so comparing results from a financial ratio analysis could be meaningless. For example, there should be some reservation in comparing the financial performance of a state-owned airline with that of a private sector airline.

As with any quantitative analysis, such as cash flow forecasts (see Chapter 20) and investment appraisal (see Chapter 21), financial ratio analysis is only partial, i.e. it does not provide a complete picture of a firm's overall performance. There are other quantitative and qualitative considerations that can help to make a better assessment of an organization's financial performance, such as:

- *Historical comparisons* - The same ratio should be compared year on year to identify any trends and, perhaps more importantly, the reasons for such trends. This can help stakeholders to determine any improvement or deterioration in the firm's financial performance.

- *Inter-firm comparisons* - Financial ratios should be benchmarked (compared) with those of close rivals to assess the relative performance of the business. A firm's ratio analysis may reveal pleasing financial results, but this might be less attractive if it had been outperformed by its competitors.

- *The nature of the business and its aims and objectives* - A profit-seeking multinational company may understandably have very different financial ratios from those of not-for-profit organizations. Similarly, businesses with a prominent social and ethical stance might strive to have somewhat lower profitability ratios.

- *The state of the economy* - A firm's financial performance may at first seem to have deteriorated but when put into the context of the business cycle (booms, peaks, recessions and slumps) may paint a different picture.

- *Social factors* - A firm's activities might be highly profitable, but financial ratio analysis does not consider the impacts on the natural environment or society. Examples of side-effects of business activity include air pollution, excess packaging and job losses due to automation and the threat of multinational companies; none of which are examined in financial ratio analysis.



Figure 18.5 - Pollution from an industrial power plant

It is also important to note that there is no internationally accepted standard in reporting the final accounts (the balance sheet and P&L account). This can make international comparisons of financial ratios very difficult and somewhat meaningless, due to the different accounting conventions used. For example, in some countries and cultures, it is perfectly acceptable for sole traders who work from home to claim

Table 18.2 - Ratio analysis summary table

Type	Ratio	Formula
Profitability	Gross Profit Margin	$\frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$
	Profit Margin	$\frac{\text{Profit before interest and tax}}{\text{Sales revenue}} \times 100$
Liquidity	Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$
	Acid test	$\frac{\text{Current assets} - \text{Stock}}{\text{Current liabilities}}$
Profitability	Return on Capital Employed	$\frac{\text{Net profit before interest and tax}}{\text{Capital employed}} \times 100$

personal income tax deductions on the costs of electricity, rent (or mortgage), telephone and the Internet.

Whilst financial ratio analysis aids management decision-making, there are limitations to what it can do and reveal. It is therefore important to consider other quantitative and qualitative factors when measuring the overall performance of a business.

Exam tip !

Often in financial ratio analysis exam questions, it is more important to consider what data are *not* given rather than just to examine the financial data provided. Good financial management decision-making considers a range of information, both quantitative and qualitative.

Common mistake

Students often forget to express their answers to the calculation of the above ratios to two decimal places. given that these ratios refer to monetary values from the balance sheet and profit, you should express your answers to two decimal places unless otherwise specified in the question.

Theory of Knowledge (TOK)

Is the use of quantitative data and information more important than qualitative knowledge claims to managers for the purpose of decision-making?

Question 18.6 - Howald-Lee & Co. vs Quintanilla Inc.

Study the data below regarding the performance of two companies, Howald-Lee & Co. and Quintanilla Inc. and then answer the questions that follow.

	Company	Year 1	Year 2	Year 3
Gross Profit Margin (%)	Howald-Lee Quintanilla	50 50	45 40	40 45
Profit Margin (%)	Howald-Lee Quintanilla	20 19	20 18	20 20
Return on capital employed (%)	Howald-Lee Quintanilla	15 12	13 10	14 15
Quick ratio	Howald-Lee Quintanilla	2.5 1.5	2.2 1.9	1.5 1.1
Gearing (%)	Howald-Lee Quintanilla	45 45	47 43	50 40

Note: SL students are not expected to use the gearing ratio in this question. HL students might want to refer to Chapter 19 before tackling this question.

(a) Define the term *quick ratio.* *[2 marks]*

(b) Distinguish between gross profit and net profit. *[4 marks]*

(c) Comment on why it is important for potential investors to consider non-financial factors when making investment decisions. *[4 marks]*

(d) Using financial ratio analysis, discuss the relative attractiveness of Howald-Lee & Co. vs Quintanilla Inc. to potential investors. *[10 marks]*

Key concept

Is there any role for **creativity** in financial accounts and ratio analysis?

Profitability and liquidity ratios and the key concepts

Changes in the external business environment (see Chapter 46) will cause changes to the financial ratios of a business. For example, higher interest rates and/or corporate taxes will tend to reduce profitability ratios, even if sales revenues have actually increased in this time period. Hence, financial ratios can change without there being any underlying change in the performance of a business. The global financial crisis of 2008 and the COVID-19 pandemic caused major havoc to businesses worldwide, with many businesses going bankrupt and unemployment reaching historical highs in many countries. Such changes will have harmed the financial performance and hence ratios, of many businesses for subsequent years. By contrast, favourable changes in the economy or advances in technology can help businesses to improve their profitability and liquidity ratios.

As with all aspects of finance and accounts, there is an ethical dimension to ratio analysis. Businesses have been known to manipulate their final accounts and the presentation of their financial ratios, thus misinforming their stakeholders. In 2013, a study by researchers at the University of Toronto and the University of Chicago found that the probability of businesses involved in accounting fraud in any given tax year is 14.5%, costing investors an average of 22% of the funds in the fraud-committing firms. The British Prime Minister George Canning (1827) put this nicely by saying "*I can prove anything by statistics except the truth.*" So, whilst creative accounting through the use of window dressing is not necessarily illegal, it does raise many ethical questions about accounting practices.

ATL Activity (Research skills)

Investigate the financial fraud committed by any one of the following institutions: Bear Stearns, Enron, Dewey & LeBoeuf, Lehman Brothers or WorldCom.

What lessons can business leaders learn from the mistakes of others?

Nevertheless, used correctly, financial ratio analysis is a useful tool for financial management and strategic analysis. It is used to assess the financial health of a business, which in turn depends on a combination of profitability, liquidity (both short-term and long term) and financial efficiency. Many managers today place great emphasis on short-term liquidity ratios, since a lack of working capital is the single largest cause of business failure (see Chapter 20). However, all categories of financial ratios are important as they are inter-related. For example, adequate gearing and sufficient liquidity should help a firm to increase its profitability in a sustainable manner. Profitable businesses that lack sufficient liquidity are unlikely to survive in the long run. Hence, it is firms with good overall financial performance that succeed and survive in the long run.

Whilst financial ratios can be used to judge the success of a business strategy, they pose a slight problem for judging the success of non-profit organizations (NPOs) such as charitable organizations and non-government organizations (see Chapter 2). As NPOs are not run to make a profit, non-financial factors need to be considered, such as using examination results to judge attainment in state-funded schools. If the school has achieved better results over time, this could suggest that its performance has improved. Another measure could be to look at how well (efficient) the school operates within its allocated budget. It might also be difficult to compare like-with-like since schools can be different in so many ways - there are religious schools, different levels of funding, different catchment areas and demographics, selective and non-selective schools, single-gender schools and so on. Hence, schools are likely to have different organizational objectives. As 'success' is judged by the extent to which organizational objectives are met, the criteria for judging success in NPOs will vary from those used for profit-seeking businesses. Hence, in judging a business strategy, there is a need to consider a range of qualitative factors and not just financial ones. Nevertheless, all business entities need to earn a financial surplus to remain sustainable.



Figure 18.6 - Ratio analysis might not be so applicable to the operations of charitable organizations

Key concept

With reference to an organization of your choice, discuss how **change** has influenced its profitability and liquidity.

Business Management Toolkit

With reference to the Boston Consulting Group matrix (see Chapter 47), discuss how a firm's management of its product portfolio can have a direct impact on its financial ratios.

REVIEW QUESTIONS

1. What is meant by ratio analysis?
2. What are the main purposes of carrying out financial ratio analysis?
3. When conducting ratio analysis, why is it important to compare like-with-like?
4. What are profitability ratios?
5. What do the gross profit margin (GPM) and profit margin ratios tell us about a firm's profitability?
6. How might a business raise its gross profit margin (GPM) and profit margin ratios?
7. What is meant by return on capital employed (ROCE)?
8. How is capital employed calculated?
9. What are liquidity ratios?
10. What is meant by the current ratio?
11. How might a business improve its current ratio?
12. What is the acid test ratio?
13. Why do many businesses prefer to use the acid test ratio rather than the current ratio?
14. What are the limitations of ratio analysis?
15. How might changes in the external business environment affect the financial performance of a business?

KEY TERMS

The **acid test ratio** (or **quick ratio**) is a liquidity ratio that measures a firm's ability to meet its short-term debts. It ignores stock because not all inventories can be easily turned into cash in a short time frame.

Capital employed is the value of all long-term sources of finance for a business, namely noncurrent liabilities plus equity.

The **current ratio** is a short-term liquidity ratio that calculates the ability of a business to meet its debts within the next twelve months.

The **gross profit margin (GPM)** is a profitability ratio that shows the value of a firm's gross profit expressed as a percentage of its sales revenue.

Liquid assets are the possessions of a business that can be turned into cash quickly without losing their value, i.e. cash, stocks and debtors.

Liquidity crisis refers to a situation where a firm is unable to pay its short-term debts, i.e. current liabilities exceed current assets.

Liquidity ratios look at the ability of a firm to pay its short-term (current) liabilities, comprised of the current ratio and the acid test (quick) ratio.

The **profit margin** is a ratio that shows the percentage of sales revenue that turns into profit, i.e. the proportion of sales revenue left over after all direct and indirect costs have been paid.

Profitability ratios examine profit in relation to other figures, comprised of the gross profit margin (GPM), profit margin and return on capital employed (ROCE) ratios.

Ratio analysis is a quantitative management tool that compares different financial figures to examine and judge the financial performance of a business.

The **return on capital employed (ROCE)** is a profitability ratio that measures the financial performance of a firm based on the amount of capital invested.



Figure 18.7 - Supermarket stock (inventory) are liquid assets

Chapter 19

Unit 3.6 - Debt/Equity ratio analysis (HL only)

"A good decision is based on knowledge and not on numbers."
- Plato (427 - 347 BC), Greek philosopher

Contents

Debt/Equity ratio analysis (HL only)	
HL content	**Depth of teaching**
The following further efficiency ratios: • stock turnover • debtor days • creditor days • gearing ratio	AO2, AO4
Possible strategies to improve these ratios	AO3
Insolvency vs bankruptcy	AO2

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Debt/Equity ratio analysis

The following efficiency ratios: (i) stock turnover, (ii) debtor days, (iii) creditor days and (iv) gearing ratio. AO2, AO4.
Possible strategies to improve these ratios. AO3
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The use of **debt and equity ratios** enables a business to calculate the value of a firm's liabilities and debts against its equity. These ratios (sometimes referred to as **efficiency ratios**) are a measure of the financial stability of the business. These ratios show how efficiently an organization's resources have been used, such as the amount of time taken by the business to sell its stock (inventory) or the average number of days taken to collect money from its debtors. Supermarkets, for example, sell their stocks faster than luxury jewellers sell their goods. There are four main additional ratios for HL students to learn: (i) stock turnover, (ii) debtor days, (iii) creditor days and the (iv) the gearing ratio.

(i) Stock turnover

The **stock turnover** ratio (or **inventory turnover** ratio) measures the number of times an organization sells its stocks within a time period, usually one year. The ratio therefore indicates the speed at which a business sells and replenishes all its stock. There are two alternative ways to calculate stock turnover:

$$\text{Stock turnover (number of times)} = \frac{\text{Cost of goods sold}}{\text{Average stock}}$$

Or

$$\text{Stock turnover (number of days)} = \frac{\text{Average stock}}{\text{Cost of goods sold}} \times 365$$

The second method expresses stock turnover in term of the average number of days it takes for a business to sell all of its inventory.

When looking at stock turnover, the cost of sales (or cost of goods sold) is used (rather than sales turnover) as stocks are valued at the cost value of the inventory to the business rather than the selling price to the customer. For example, if a business has cost of sales equal to $100,000 and an average stock level valued at $20,000 then the stock turnover ratio:

- $100,000 / $20,000 = 5 times a year or
- ($20,000 / $100,000) × 365 = 73 days.

This means that the business sells all of its inventory, which is then replenished, five times a year or every 73rd day, on average. Using the first calculation, the higher the ratio the better it is for the business because more stock is sold and therefore the more efficient it is in generating profit. A high stock turnover also means that perishable stocks, such as fresh milk or freshly baked cakes, do not expire or stocks do not become out of dated. By contrast, a lower number is better when using the second calculation, as 73 days to replenish stocks is highly undesirable for businesses dealing with perishable products.



Figure 19.1 - Firms that sell perishable products need to have a high stock turnover rate

There are several ways that an organization's stock level can be reduced to improve its stock turnover ratio:

- Holding lower stock levels requires inventories to be replenished more regularly (which can have both advantages and disadvantages - see Chapter 40).
- Divestment (disposal) of stocks which are slow to sell, i.e., getting rid of obsolete stock and unpopular products in the firm's portfolio.
- Reduce the range of products being stocked by only keeping the best-selling products.

When comparing this ratio, it is important (as always) to compare like-with-like. Different businesses have different benchmark figures for stock turnover. For example, a restaurant should expect a significantly higher stock turnover ratio (by times) than a seller of luxury motor vehicles. A stock turnover rate of 6 times a year is perhaps acceptable to suppliers of consumer durables, but unacceptable to a florist or fresh fish monger. Hence, a low stock turnover ratio is not necessarily a bad sign; all ratios must be put into context.

(ii) Debtor days

The debtor days ratio measures the number of days it takes a business, on average, to collect money from its debtors. Hence, it is sometime referred to as the **debt collection period**. Debtors are the customers who have purchased items on trade credit and therefore owe money to the business. It is calculated using the formula:

$$\text{Debtor days} = \frac{\text{Debtors}}{\text{Total Sales revenue}} \times 365$$

where total sales revenue is an approximation of the firm's total credit sales

For example, if an organization's debtors (shown on its balance sheet) totals $1 million whilst its sales turnover is $5 million, then the debtor days ratio is: ($1m / $5m) × 365 = 73 days.

This means it takes the business an average of 73 days to collect debts from its customers who have bought items on credit. Logically, the less time it takes for customers to pay their debts, the better it is for the business. There are two reasons for this: first, the business improves its cash flow if customers pay on time and second, due to the opportunity cost of holding onto money, the business could invest this money in other revenue-generating projects. However, a debtor days ratio that is too high or too low can also be problematic:

- Although businesses may allow customers to buy on credit, it is important that the credit period granted is not too long otherwise the businesses could face liquidity problems (see Chapter 20).

- Equally, too low a debtors day ratio suggests customers may seek other suppliers if the credit period given to them is uncompetitive because clients prefer better credit terms.

It is quite common to allow customers between 30 to 60 days credit. The organization's ability to collect debts within a suitable timeframe is known as **credit control**. A business is generally seen as having good credit control if it can collect debts within 30-60 days. Businesses can improve their debt collection period in several ways:

- Impose surcharges on late payers. For example, banks and utility companies add a fine to those who pay their bills late. In a similar way, in many countries, the government will impose a surcharge on income tax bills for late payers.

- Give debtors incentives to pay earlier, such as giving a discount to those who pay their bills before the due date. Many businesses encourage their credit customers to use *direct debit* or *autopay*. These are financial services that involve transferring money owed to creditors by using funds directly from the client's bank account on designated days. This saves customers having to remember when to pay their bills and hence avoid penalties for late payments.

- Refuse any further business with a client until payment is made. This may include stopping supplies to a customer or suspending an order until payment is received.

- Threaten legal action. The threat of taking a customer to court is rather extreme but is often used for clients who repeatedly pay late.

Some businesses, such as suppliers of expensive luxury goods, rely more on credit sales than others. Hence, for these businesses it is more acceptable to have a higher debt collection period. Fast food restaurants or hair salons, on the other hand, have customers paying for their goods at the time of purchase so their debt collection period would be much lower.



Figure 19.2 - Suppliers of luxury goods, such as yachts, rely on credit sales

(iii) Creditor days

The creditor days ratio measures the number of days it takes, on average, for a business to pay its trade creditors. The formula for this ratio is:

$$\text{Creditor days} = \frac{\text{Creditors}}{\text{Cost of goods sold}} \times 365$$

where cost of sales is an approximation of the firm's total credit purchases

For example, if a business has $225,000 owed to its suppliers (as seen from its balance sheet) with $2 million worth of cost of sales (or cost of goods sold), then the creditor days ratio is ($225,000 / $2m) × 365 = 41 days. This means the business takes 41 days on average to pay its suppliers. It is common to provide customers with 30-60 days credit, so a creditor days ratio in this range would generally be seen to be acceptable.

A high creditor days ratio means that repayments are prolonged. This can help to free up cash in the business for other use (in the short term). However, a high creditor days ratio might also mean that the business is taking too long to pay its trade creditors so suppliers may impose financial penalties for late payment. In this case, a high creditor days ratio will harm the firm's cash flow position.

In theory, the efficiency position of a business can be enhanced by improving any of its efficiency ratios, i.e., increasing stock turnover, reducing debtor days and increasing creditor days. Strategies to achieve this include:

- Developing closer relationships with customers, suppliers and creditors, thereby helping to reduce the debt collection time and extend the credit period.
- Introduce a system of just-in-time production (see Chapter 37) to eliminate the need to hold large amounts of stocks and to improve stock control.
- Improve credit control, i.e., managing risks regarding the amount of credit given to debtors. For example, giving customers an incentive to pay earlier or on time helps to reduce the chances of bad debts (money owed to the business that does not get repaid).

(iv) Gearing ratio

The **gearing ratio** is used to assess an organization's long term liquidity position. This is done by examining the firm's capital employed that is financed by long term debt (noncurrent liabilities), such as mortgages (see Chapter 14). The gearing ratio enables managers to gauge the level of efficiency in the use of an organization's capital. The gearing ratio formula is:

$$\text{Gearing ratio} = \frac{\text{Noncurrent liabilities}}{\text{Capital employed}} \times 100$$

Or

$$\text{Gearing ratio} = \frac{\text{Loan capital}}{\text{Capital employed}} \times 100$$

where capital employed = Noncurrent liabilities + Equity

For example, a business with noncurrent liabilities totalling $5 million whilst its capital employed is $15 million has a gearing ratio of ($5m / $15m) × 100 = 33.3%. This means that one third of the organization's sources of finance comes from external interest-bearing funds, whilst the other two-thirds represent internal sources of finance. Recall from Chapter 18 that capital employed is comprised of the firm's loan capital (noncurrent liabilities) and equity (share capital plus retained earnings).

The higher the gearing ratio, the larger the firm's dependence on long term sources of borrowing (as shown by the value of noncurrent liabilities on the balance sheet). This means that the business incurs higher costs due to debt financing, such as interest repayments to banks or debenture holders (see Chapter 15). This can therefore limit the overall profit for the business.

Creditors and investors are interested in the level of gearing of a business. A firm is said to be *highly geared* if it has a gearing ratio of 50% or above. Such businesses are more vulnerable

Question 19.1

(a) Use Tables 18.1 and 18.2 to calculate the following ratios for JKL Ltd., for both years:

(i) stock turnover *[2 marks]*

(ii) debtor days and *[2 marks]*

(iii) creditor days. *[2 marks]*

(b) Examine the ways in which JKL Ltd. could improve its efficiency position. *[6 marks]*

(c) Using your answers from part **(a)** above, explain the efficiency position of JKL Ltd. *[6 marks]*

to increases in interest rates. This situation is similar to an individual who has a large mortgage with a bank. A rise in interest rates will mean such individuals will have higher monthly interest repayments on their outstanding mortgages. Similarly, a highly geared business will be more exposed to interest rate hikes or if there is a downturn in the economy as loan repayments remain high whilst cash inflow from sales will tend to fall in a recession. Other financiers are less likely to lend money to firms that are already highly geared due to their large loan commitments.

Shareholders and potential investors are also interested in the gearing ratio as it helps to assess the level of risk. Since financiers have to be repaid first (with interest), this may reduce the amount paid to shareholders and the amount retained for reinvestments. However, if the profitability of the business is high (see Chapter 18), then potential returns can be very attractive even in highly geared firms.

Although gearing can make profits more volatile, businesses tend to require external finance to fund their expansion. The phrase 'you need money to make money' suggests that external financing can help businesses to grow, even if this raises the level of gearing. The issue is how much debt the business can handle before the benefits of growth outweigh the costs of higher gearing and exposure to financial risks. The level of gearing that is acceptable to a business will depend on several factors, including:

- The size and status of the business - Generally, there is a positive correlation between a firm's size and status and its ability to repay long term debts. Most stakeholders would not worry too much if McDonald's or Walmart had a gearing ratio of 50% as it is likely to be able to repay the debt.
- The level of interest rates - If interest rates are low, then businesses are less vulnerable (at least in the short term) even with a high gearing ratio. For example, the 2008 global financial crisis caused many governments across the world to reduce interest rates close to zero percent. This minimises the interest repayments on long term external finance.
- Potential profitability - If businesses have good *profit quality* (long term prospects of earning profit), then high gearing is less likely to be an issue. This applies to many businesses in high-tech industries that invest heavily in research and development. They may need external finance to fund the expenditure on R&D but the potential for high returns can minimise their exposure to gearing.

Theory of Knowledge (TOK)

At what time does a business know or decide to expand?

Question 19.2

(a) Calculate the gearing ratio for JKL Ltd. for both years. *[2 marks]*

(b) Explain what the gearing ratios tell you about JKL Ltd.'s long-term liquidity position. *[4 marks]*

(c) Examine whether high gearing can actually be beneficial to organizations like JKL Ltd. *[6 marks]*

Question 19.3 - Ocean Deco Limited

Ocean Deco Limited is a company that specializes in the renovation of commercial properties, such as painting, decorating, repairs and maintenance of retail outlets. The company was started in 2009 by Chris DelPreore and his son, who had graduated from London Business School in the same year.

As a relatively small business, Ocean Deco Limited has faced problems in securing **external finance** although it did manage to take out an $80,000 mortgage this year to fund its expansion plans. Ocean Deco Limited has been approached by a larger company, Vintage Commercial Ltd., with an offer of a takeover. Chris DelPreore is reluctant to sell the family business that he helped to establish. However, his son is attracted by the lucrative deal and has advised his father that Ocean Deco Limited can no longer compete with its larger rivals that use the latest industrial tools and equipment to enhance their productivity.

Extract from the profit and loss account and balance sheet of *Ocean Deco Limited:*

	$'000
Sales revenue	532
Cost of sales	248
Expenses	132
Noncurrent assets	145
Current assets	85
Current liabilities	62
Owners' Capital	88
Long-term liabilities	80



(a) Define the term *external finance.* *[2 marks]*

(b) Calculate the following ratios for *Ocean Deco Limited:*

(i) Gross profit margin (GPM) *[2 marks]*

(ii) Return on capital employed (ROCE) *[2 marks]*

(iii) Gearing. *[2 marks]*

(c) Using the above ratios, explain why Vintage Commercial Ltd. might be interested in taking over Ocean Deco Limited. *[4 marks]*

(d) Considering both numerical and non-numerical factors, recommend to the owners of Ocean Deco Limited whether they should accept or reject the takeover bid. *[10 marks]*

Table 19.1 - Efficiency ratio analysis summary table

Ratio	Formula
Stock turnover	$\frac{\text{Cost of goods sold}}{\text{Average stock}}$ OR $\frac{\text{Average stock}}{\text{Cost of goods sold}} \times 365$
Debtor days	$\frac{\text{Debtors}}{\text{Total sales revenue}} \times 365$
Creditor days	$\frac{\text{Creditors}}{\text{Cost of sales}} \times 365$
Gearing	$\frac{\text{Noncurrent liabilities}}{\text{Capital employed}} \times 100$

Question 19.4 - ACS Playframes Limited

ACS Playframes Limited (ACSPL) specializes in manufacturing and distributing children's play frames. The privately held company, set up by Pamela Ng, employs 5 full-time staff and several part-time staff.

ACSPL has enjoyed several years of expansion in the provision of their playframes to hotels, schools and the local government. However, several larger foreign rivals have recently established a presence in the market. The booming economy has also meant that interest rates are on an upwards trend.

Pamela has been informed by Alka Hingle, her accountant, that the company's costs of external financing have risen dramatically. Alka presented the following financial information for ACSPL (as of 31st March of this year) which raised some working capital and liquidity issues:

Cost of sales	$900,000
Current assets	$600,000
Current liabilities	$550,000
Expenses	$600,000
Fixed assets	$7,500,000
Noncurrent liabilities	$3,200,000
Retained profit	$850,000
Sales revenue	$3,500,000
Shareholders' funds	$3,500,000



(a) Define the term *noncurrent liabilities*. *[2 marks]*

(b) Construct a profit and loss account for ACSPL using the figures above. *[4 marks]*

(c) (i) Calculate the value of the current ratio. *[2 marks]*

(ii) Calculate the value of the gearing ratio. *[2 marks]*

(iii) Using your answer from part (c) (i) and the information in the case study, explain why ACSPL is said to have 'some working capital and liquidity issues'. *[4 marks]*

(d) Examine **two** financial strategies that Pamela could use to deal with her company's working capital and liquidity issues. *[6 marks]*

HIGHER LEVEL

Theory of Knowledge (TOK)

Is the use of quantitative data and information more important to managers than qualitative knowledge claims?

Theory of Knowledge (TOK)

Numbers can be manipulated in such a way that they can reveal any 'truth' that is desired. To what extent do you agree with this statement?

Insolvency versus bankruptcy (AO2)

Insolvency occurs when individuals (such as sole traders and partners) or organizations as legal business entities are unable to settle their debts when they are due because of the lack of funds or cash in their bank accounts. This occurs mainly due to one of two reasons:

- Cash flow insolvency - This occurs when an insolvent firm cannot make a payment owed to creditors because it does not have the cash to do so.
- Balance sheet insolvency - This occurs when the liabilities (debts) of the firm exceed its assets.

There are several solutions for resolving insolvency, such as borrowing money (although this might depend on the firm's existing gearing ratio), cutting costs or selling off noncurrent assets in order to raise funds to pay off the debts. Firms might also be able to negotiate a debt payment or settlement plan with their creditors, although this is likely to damage their future credit ratings.

By contrast, **bankruptcy** is the formal and legal declaration of an individual's or organization's inability to settle its debts. This means that the business owes so much that selling all its assets will not cover the debts owed. Hence, the business has failed and is unable to continue trading. Bankruptcy is a last resort and occurs when all attempts to tackle insolvency have failed. At the end of the bankruptcy period, any outstanding debts of the business are terminated and creditors can no longer demand payment, charge interest or take further legal action against the firm. However, bankruptcy can severely damage the credit rating of the owners of a business, hindering their ability to borrow money for many years ahead.

So, a business can be insolvent without being bankrupt, but it cannot go bankrupt without first being insolvent. Insolvency is a financial state that a business might find itself in, whereas bankruptcy is a legal declaration and process involving individuals or firms unable to pay off their debts. In legal terms, insolvency applies to individuals and corporations, whereas bankruptcy applies to individuals only. In both cases though, as insolvent and bankrupt businesses are prone to experience financial difficulties, they may be taken over by larger competitors.

To understand these two ideas, it is important to look at the firm's liquidity position and its working capital cycle.

The term **liquidity** refers to how easily an asset can be turned into cash. Highly liquid assets are those that can be converted into cash quickly and easily without losing their monetary value, such as cash deposits at a bank. Raw materials, on the other hand, would be relatively illiquid current assets as they cannot be changed into cash as easily or quickly.

Evidence from around the world consistently shows that insufficient working capital (the difference between a firm's current assets and its current liabilities) is the single largest cause of business failure, rather than a lack of profitability. Inadequate working capital leads to insolvency. This can lead to the collapse of the business as creditors will take legal action to recover their money. This can trigger the liquidation of the business, i.e., it will need to sell off its assets to repay as much of the money owed to its creditors.

Working capital (or **net current assets**) is calculated using the formula:

Working Capital = Current Assets – Current Liabilities

Current assets are the liquid resources belonging to a business that are expected to be converted to cash within the next twelve months. The three main types of current assets are cash, stocks and debtors (see Chapter 17). **Current liabilities** refer to the money that a business owes that needs to be repaid within the next twelve months. These include bank overdrafts, trade creditors and other short-term loans.

For most businesses, there is a delay between paying for costs of production (such as the purchase of stocks or payment of wages) and receiving the cash from selling their products. This is because the production process takes time. For example, consider the time lag from receiving an order for a new Ferrari and actually receiving the cash once the car is finally handed over to the customer. Construction companies also tend to experience long working capital cycles. The interim period between cash payments for costs of production and cash receipts from customers is known as the **working capital cycle** (see Figure 19.3). The delay means that businesses must manage their working capital carefully in order to avoid insolvency issues.

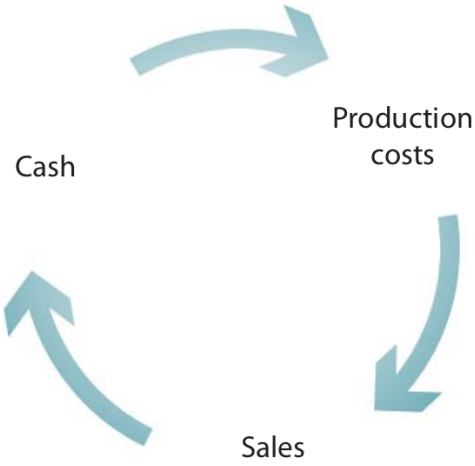

Figure 19.3 - The working capital cycle



Figure 19.4 - Construction firms tend to have a long working capital cycle

ATL Activity (Research skills)

Investigate why profitable businesses may face insolvency. Be prepared to present your findings to the rest of the class.

Question 19.5 - Le Royal Méridien Hotels

Le Royal Méridien is a luxury five-star hotel chain that operates in many parts of the world, including Bristol (UK), Hamburg (Germany), Koh Samui (Thailand), Mumbai (India) and Toronto (Canada). The parent company, Marriott International, has plans for continued expansion in the world's top cities. However, the construction of a typical Le Royal Méridien hotel takes between 2 to 3 years. This means the hotel group must maintain sufficient working capital at all times to avoid **insolvency** issues.



Le Royal Méridien in Dubai

(a) Define the term *insolvency.* *[2 marks]*

(b) Explain why Le Royal Méridien needs better cash flow management when there is a long working capital cycle during the construction of its new hotels. *[4 marks]*

Efficiency ratios and the key concepts

The key concepts were applied to profitability and liquidity ratios in Chapter 18. Additionally, creativity and product innovations can help businesses to improve their efficiency and long-term profitability. Apple, for example, became the world's largest company in January 2012 after hugely successful product launches such as the iPad and iPhone. In early 2022, Apple became the world's first company to be valued at $3 trillion. By contrast, the inefficiencies and lack of profit quality of Sony led to a steady decline in its market share in the consumer electronics industry during the same time period.

Creativity also presents many business with growth opportunities, leading to a generally positive impact on financial ratios. However, with a wider customer base across the globe due to growth opportunities, managing debtors can become increasingly challenging. Multinational companies trying to exploit the benefits of growth and evolution (see Chapter 5) will also need sufficient finance to fund their growth strategies. This can have a detrimental impact on their gearing ratio, at least in the short run.

It is important to be reminded that when analysing the financial performance of a business, the calculations should always be put into the context of the market in which the firm operates organizational objectives (see Chapter 3) and its organizational culture (see Chapter 11). A gearing ratio of over 50% is perhaps acceptable to a large multinational company that is expanding into overseas markets with huge growth potential. This may be far less sustainable for a business that sells products in niche markets, such as hand-made ukuleles. Similarly, producers of solar panel units may grant a longer credit period to property developers, whereas this is unlikely for supermarkets and retailers of fast-moving consumer goods (see Chapter 27).



Figure 19.5 - Hand-made ukuleles are a niche market product

A high ROCE ratio is not necessarily indicative of a sustainable business strategy either as the figure should be compared with historical performance, inter-firm data, interest rates offered by banks and the expected returns from alternative projects. The context also includes consideration of other business management tools, such as STEEPLE analysis (see Chapter 46), which examines the economic, social and political environments in which the business operates. Poorer liquidity is expected during a recession, for example. There is also a time lag between strategic implementation and the realisation of profits; this lag will vary from one industry to another. Nevertheless, ratio analysis can provide some invaluable information for the strategic implementation of business plans as well as helping managers and decision makers to face the challenges of changes in the business environment.

Theory of Knowledge (TOK)

What is the definition of a number? What role does mathematics have as an area of knowledge in the study of Business Management?

Key concept

Discuss how **creativity** can influence the efficiency ratios of an organization of your choice.

Business Management Toolkit

Discuss how knowledge of product portfolio analysis (see Chapter 47) can help businesses to improve their debt/equity ratios.

Exam tip !

Learn your vocabulary. There is a lot of technical jargon used in finance and accounts. Quite often, the terms are self-explanatory or intuitive (such as 'shareholder' or 'cost of goods sold'). However, some need more thought (such as 'gearing' or 'acid test'). Try to understand *why* the terms are used. For example, did you know that the word 'dividends' comes from the words 'divide' and 'end', i.e. the profits after interest and tax that are *divided* at the *end* of the fiscal year for the owners of the company?

Exam tip !

Examination questions typically ask students to use financial ratios to comment on an organization's:

a) profitability

b) liquidity position

c) efficiency position and

d) gearing

These are the main categories of ratios! Make sure that you know their meanings and the different types of ratios within each category.

REVIEW QUESTIONS

1. What are debt and equity ratios (efficiency ratios)?
2. What is meant by the stock turnover ratio?
3. What are the two ways to calculate the stock turnover ratio?
4. What is meant by the debt days ratio?
5. What is meant by credit control?
6. What is meant by the creditor days ratio?
7. How is the creditor days ratio calculated?
8. What is the gearing ratio?
9. How is the gearing ratio calculated?
10. How is capital employed calculated?
11. Why are highly geared businesses generally considered to be risky?
12. What is meant by insolvency?
13. What is meant by bankruptcy?
14. What is meant by liquidity?
15. What is the working capital cycle?

KEY TERMS

Bankruptcy is the legal process declared by the courts that occurs when an individual or business entity is unable to repay its debts.

Credit control refers to the ability of a business to collect its debts within a suitable timeframe.

Creditor days ratio is an efficiency ratio that measures the average number of days it takes for a business to pay its creditors.

Debt and equity ratios (sometimes referred to as **efficiency ratios**) enable a business to calculate the value of their liabilities and debts against their equity. These ratios are a measure of the financial stability of the business.

Debtor days ratio is an efficiency ratio that measures the average number of days it takes for a business to collect the money owed from debtors.

The **gearing ratio** measures the percentage of an organization's capital employed that comes from external sources (noncurrent liabilities), such mortgages.

Insolvency is a financial state where an individual or business entity is unable to pay its debts on time. If insolvency cannot be resolved, this can lead to bankruptcy.

Liquidity refers to how easily an asset can be turned into cash. Highly liquid assets are those that can be converted into cash quickly and easily without losing their monetary value.

Profit quality refers to the ability of a business to earn profit in the foreseeable future. A business with good profit quality is able to earn profit in the long run.

Stock turnover ratio (or **inventory turnover ratio**) measures the number of times a business sells its stocks within a year. It can also be expressed as the average number of days it takes for a business to sell all of its inventory.



Figure 19.6 - Bankruptcy causes a business to close permanently

Chapter 20
Unit 3.7 - Cash flow

"Don't empty the water jar until the rain falls."
- English Proverb

Contents

3.7 Cash flow	
SL/HL content	**Depth of teaching**
The difference between profit and cash flow	AO2
Cash flow forecasts	AO2, AO4
The relationship between investment, profit and cash flow	AO2
Strategies for dealing with cash flow problems	AO3

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The difference between profit and cash flow (AO2)

Cash is often described as the lifeblood of a business because every organization needs cash to keep functioning. Cash is needed to pay for daily costs such as wages and electricity. Failure to pay suppliers and trade creditors may eventually result in a business being declared bankrupt. Cash is a current asset. It is the money that a business actually receives from the sale of goods and services. It can be either held 'in hand' (actual cash in the business) or 'at bank' (cash held in a bank account).

Profit in its simplest form is the positive difference between a firm's total sales revenue and its total costs of production for a given time period. When a sale is made, this contributes towards paying the firm's costs. When enough products are sold to pay for all costs, the firm reaches its break-even point (see Chapter 39). Any sales beyond a firm's break-even point generates profit for the business.

Profit = Total revenue – Total cost

When making a purchase, customers might have several payment options, such as cash or credit. Paying by credit means that customers can buy now but pay later. For example, a credit period of 30 days means that customers do not need to pay for their purchases until a month later. This might attract more customers but can also cause cash flow problems for the business as it will need to operate without immediate payment from its credit customers.

When a firm sells its products on credit, it automatically earns a contribution on the sale, assuming price exceeds unit costs of production (see Chapter 57). However, as customers pay on credit, the firm does not receive the cash at the time of purchase. Hence profit is made *before* the cash is received, i.e. profit is not the same as cash. For example, if a firm sold $50,000 of goods in a month, with 60% of its customers paying by cash, then only $30,000 cash is received. The other 40% (or $20,000) is not received until the end of the credit period. Hence, the sales revenue ($50,000) is not the same as the cash inflow ($30,000)

during the month. Profit is made only after all production costs are paid for.

It is therefore possible for a firm to be profitable but cash deficient. The main reason is because there is poor credit control, which damages the firm's cash flow position. Another case is when a profitable business tries to expand too quickly, so runs out of cash. Seasonal variations in demand can also mean that there are certain times in the year when the firm might experience short-term liquidity problems. **Liquidity** is the ability of a business to convert assets into cash quickly without a fall in its value (see Chapter 19). Ultimately, a business cannot operate without sufficient cash to pay its suppliers, employees and financiers, i.e. a lack of cash will eventually lead to a firm going bankrupt.

Conversely, it is also possible to be cash rich but unprofitable. The initial hype for a new product might bring in plenty of cash for a business but unless the firm is able to control its costs, including its fixed and indirect costs (see Chapter 15), the business will not be profitable. Hence, all businesses, however profitable, must manage their cash flow position in order to survive.

Case study 20.1 - Marks & Spencer

UK retailer Marks & Spencer (M&S) was established in 1884. In 2018, the company announced it would close 100 stores by 2022 due to declining profits and cash flow problems. The chief executive officer, Steve Rowe, said customer preference for online shopping and the growing presence of no-frills retailers (such as Primark, Aldi and Lidl) were to blame. Rowe also announced that the first phase of store closures would cost M&S over £321 million ($450 million). However, the COVID-19 pandemic caused major cash flow issues for M&S, causing the company to make losses of £200 million ($280 million).

CORE

Question 20.1 - McDonald's

In keeping with the times, fast food giant McDonald's has revamped its traditional menus since 2003. It has added healthier options such as salads, pastas, soups, smoothies, and bottled water. The company's endeavours to gain more revenue led to its global "I'm lovin' it" marketing campaign, extended opening hours and new facilities to allow customers to pay with their credit cards and smartphones. In 2012, McDonald's reported its annual sales revenues had increased to $27.5 billion, although **net profits** were only $5.5bn, its first decline in nine years. However, by the end of 2019, despite earning lower revenues of $21bn, the company declared higher net profits of just over $6bn.



(a) Define the term *net profits.* *[2 marks]*

(b) Explain how it is possible for McDonald's to report an increase in sales revenues but a fall in its net profits. *[4 marks]*

(c) Explain how the use of credit cards might help to increase sales yet cause cash flow issues for McDonald's *[4 marks]*

Cash flow forecasts (AO2, AO4)

A **cash flow forecast** is a financial tool used to show the expected movement of cash into and out of a business, for a given period of time. It is based on three key elements:

- **Cash inflows** - This refers to cash that comes into a business during a given time period, usually from sales revenue when customers pay for the products that they have purchased. Cash inflows can also come from payments made by debtors, funds from bank loans, interest received from savings deposits, the sale of fixed assets or rental income charged on property owned by the business. Predicting cash inflows requires accurate sales forecasting (see Chapter 25).

- **Cash outflows** - This refers to cash that leaves a business during a given time period, such as when invoices or bills have to be paid. A cash flow forecast therefore requires a detailed budget with itemised expenses such as rent, wages, purchase of stocks (inventories), taxes, payments to creditors, advertising, loans plus interest repayments and dividend payments.

- **Net cash flow** - This refers to the difference between cash inflows and cash outflows for a given time period, usually per month. Ideally, net cash flow should be positive, although it is possible for a firm suffering from negative net cash flow to survive temporarily. Even if a business is profitable, it can only survive in the long run if its receipts (cash inflows) are greater than its expenses (cash outflows).

Suppose that a business buys imported games consoles from Japan at an average cost of $100 and sells these at an average price of $350. Each device sold earns the business a contribution of $250, irrespective of whether customers pay by cash. However, if some customers pay by trade credit, then this will reduce the value of cash inflows for that particular trading period.

Exam tip !

If you receive a regular allowance (or pocket money), consider how you would feel and be affected if, for whatever reason, you did not receive any cash when you next expect to. Businesses are no different - they cannot operate without a sufficient stream of cash inflow.

Reasons for cash flow forecasts

- Banks and other lenders require a cash flow forecast to help them assess the financial health of the business seeking external sources of finance (see Chapter 15).

- They can help managers to anticipate and identify periods of potential liquidity problems, i.e. times of cash deficiency. Managers can then plan accordingly, perhaps by arranging bank overdrafts or adjusting the timing of cash inflows and cash outflows to avoid liquidity problems.

- They facilitate business planning. Good financial control is not only socially responsible but can help a business to better achieve its organizational objectives (see Chapter 3). Forecasts can be compared with actual cash flows in order to improve future predictions (cash flow forecasts) and planning.

Question 20.2 - Garima Khurana Enterprises

Garima Khurana Enterprises is a shoe retailer in Morocco. The data below are excerpts from the firm's cash flow statement for last month. All figures are in Moroccan dirham (MAD).



Opening balance:	MAD33,000
Total **cash inflows**:	MAD135,000
Total cash outflows:	MAD103,000

(a) Define the term *cash inflows.* *[2 marks]*

(b) Calculate the net cash flow for Garima Khurana Enterprises. *[2 marks]*

Exam tip !

Make sure you can distinguish between *cash flow forecasts* and *cash flow statements*. A cash flow statement is a financial document that shows the details of *actual* cash inflows and outflows for a given time period. It can be used to help prepare subsequent cash flow forecasts, which are *predictions* of cash inflows and cash outflows.

Constructing cash flow forecasts

Consider the following numerical example which shows a simplified six-month cash flow forecast for Rachel Proffitt Trading Co. Assume that the firm receives $4,000 of rental income in November. It is common to show negative numbers in a cash flow forecast by using brackets.

In addition to the three key components in a cash flow forecast outlined above, there are two other important parts:

- The **opening balance** is the amount of cash at the beginning of a trading period. Notice that the opening balance is the same value as the preceding month's closing balance. For example, at the close of business on 31st July, the cash balance was $3,000 so it is logical that the opening balance on 1st August is the same value, i.e. $3,000.
- The **closing balance** is the amount of cash at the end of a trading period. It is calculated by using the formula: Closing balance = Opening balance + Net cash flow. For example, although the net cash flow (the difference between cash inflows and cash outflows) is negative $2,000 in July, the closing balance is positive $3,000 due to the opening balance of $5,000 in July.

Notice that the company has a negative closing balance in September and October. A business cannot survive without sufficient cash, so the cash flow forecast can help the firm to devise plans to deal with cash shortages. For example, Rachel Proffitt Trading Co. might seek to take out a bank overdraft (see Chapter 15) as a short-term solution to deal with the expected liquidity problems in September and October.

Table 20.1 - Simplified cash flow forecast for Rachel Proffitt Trading Co. (figures in $)

	Jul	Aug	Sept	Oct	Nov	Dec
Opening balance ($)	5,000	3,000	300	(1,400)	(2,600)	600
Inflows ($)						
Cash sales revenue ($)	6,000	5,000	6,500	6,800	7,500	9,500
Other income ($)	0	0	0	0	4 000	0
Total cash inflows ($)	6,000	5,000	6,500	6,800	11,500	9,500
Outflows ($)						
Stock ($)	2,500	2,200	2,700	2,700	3,000	3,300
Labour costs ($)	3,500	3,500	3,500	3,500	3,500	3,500
Other costs ($)	2,000	2,000	2,000	1,800	1,800	2,200
Total cash outflows ($)	8,000	7,700	8,200	8,000	8,300	9,000
Net cash flow ($)	(2,000)	(2,700)	(1,700)	(1,200)	3,200	500
Closing balance ($)	3,000	300	(1,400)	(2,600)	600	1,100

Exam tip! - Worked example

Study the cash flow forecast below to complete the missing values for (a)–(e). *[5 marks]*

	Sept ($)	Oct ($)	Nov ($)	Dec ($)
Opening balance	1,000	**(c)**	1,600	1,900
Cash inflows	2,000	2,000	**(d)**	4,000
Stock purchases	600	600	900	1,200
Rent	1,000	0	1,000	0
Other costs	600	600	800	1,000
Net cash flow	**(a)**	800	300	1,800
Closing cash balance	**(b)**	1,600	1,900	(e)

Answers:

(a) Cash inflow in September from cash sales is $2,000. The total cash outflow is $2,200 (the sum of stock purchases, rent and other costs). Net cash flow is the difference between cash inflows and cash outflows for the month, so the value of (a) = (**$200**), i.e. there is negative net cash flow of $200.

(b) The closing balance = opening balance + net cash flow. Hence, the value of (b) = $1,000 + ($200) = **$800**.

(c) The opening balance in October is the same value as the closing balance in September. Hence, the value of (c) = **$800.**

(d) The total cash outflow in November is $2,700 (i.e. $900 + $1,000 + $800). The net cash flow is given as $300. This means the cash sales exceeded the cash outflow figure by $300, so the value of (d) = **$3,000.**

(e) The closing balance at the end of December is worked out in the same way as working out the value of (b), i.e. opening balance + net cash flow for the month. Hence, the value of (e) = $1,900 + $1,800 = **$3,700.**

Exam tip !

So why should you lay out your cash flow forecasts in the examinations? Whilst there are different conventions of presenting the order of a cash flow forecast, use the format below as prescribed by the IB. This format applies to both for-profit and non-profit business entities.

Cash flow forecast for (Business X), for the first three months of 20XX			
All figures in $'000	**Jan**	**Feb**	**Mar**
Opening balance	10	20	15
Cash inflows			
Cash sales revenue	200	180	190
Tax refund		10	
Total cash inflows	200	190	190
Cash outflows			
Rent	20	20	20
Packaging	5	5	5
Salaries and wages	30	30	30
Cost of sales	100	110	105
Heating and lighting	20	15	10
Delivery	15	15	15
Total cash outflows	190	195	185
Net cash flow	10	-5	5
Closing balance	20	15	20

Source: Adapted from IB Business Management Guide, page 62

Question 20.3 - Menelao Stationers



Denise Menelao has recently received her license to set up a stationery outlet called Menelao Stationers in Long Beach, California, USA. Her main targeted clients are from the business sector, such as local schools and offices. She plans to commence trading on 1st August and has initial capital of $6,500 that she puts into her business bank account. Denise Menelao has also compiled the following information:

- Sales for the first four months are forecast to be: $2,000 (Aug), $5,500 (Sept), $3,200 (Oct) and $3,000 (Nov).
- Stock purchases cost exactly half the value of sales each month.
- Rent is paid every two months, starting in September. Each payment is $2,000.
- Utility bills are predicted to average $500 per month.
- Other expenses are expected to be $1,800 for the first month and $1,100 per month thereafter.

(a) Use the above information to construct a cash flow forecast for Menelao Stationers. *[6 marks]*

(b) Explain the liquidity position of Menelao Stationers. *[4 marks]*

Question 20.4 - Wincent Computing Ltd.

Morten Wincent has recently opened a computer hardware business in a busy location. He expects most of his customers will purchase products using credit. He has created the following cash flow forecast for the next three months of trading. He feels this is optimistic but realistic, especially as the firm has yet to spend any money on marketing. Although Wincent Computing Ltd. allows its customers up to 60 days credit, its suppliers only give the business trade credit of 14 days.

	Month 1 ($)	Month 2 ($)	Month 3 ($)
Sales revenue	25,000	20,000	22,000
Overdraft		8,000	0
Cash inflow	28,000		22,000
Cost of goods sold	16,250		14,300
Staff wages	4,000	4,500	4,300
Expenses	5,000	5,000	5,000
Other costs		1,600	1,850
Total cash outflow	26,750	24,100	
Net cash flow	1,250		(3,450)
Opening balance	(1,750)	(500)	3,400
Closing balance		3,400	(50)

(a) Complete the missing figures in the cash flow forecast for Wincent Computing Ltd. *[4 marks]*

(b) Explain **two** possible causes of cash flow problems for Wincent Computing Ltd. *[4 marks]*

(c) Explain **two** ways that Wincent Computing Ltd. might be able to resolve its anticipated cash flow problems. *[4 marks]*

Exam tip !

Remember there is a difference between **sales revenues** and **cash inflows.** The former comes from a single source, i.e. customers. Cash inflows can come from non-revenue sources, such as selling dormant (unused) assets to generate cash, receiving bank loans, receiving donations or obtaining government grants.

The relationship between investment, profit and cash flow (AO2)

As previously mentioned, cash is not the same as profit. A business could be making a loss, but has plenty of cash or it could be profitable but lack favourable cash flow. For example, a new franchisee might run a cash-rich business as there are lots of customers but is unprofitable because of the huge investment costs involved in the short-term, such as the start-up costs of the franchise (including buildings and capital equipment), training and recruitment costs and supplies of stocks (inventory). **Investment** is the spending on capital or productive assets, such as production facilities, business premises and machinery. Over time, the franchisee may become profitable, but financing growth (buying more franchised outlets) could mean the owner becomes cash deficient.

Investment expenditure helps the business to produce and supply goods or services that generate future cash flows and generate profits for the business. An example of the relationship between investment, profit and cash flow is when a business purchases an asset (investment) it experiences a fall in its cash flow position, although this can improve its profits in the future. The opposite happens when a business sells an asset (divestment), which improves its cash flow position but usually happens due to falling profits.

Case study 20.2 - Lenovo

Investment expenditure requires the use of cash, so net cash flow is likely to be negative in the short term. For example, Lenovo bought Motorola from Google for $3bn in 2014. Lenovo hoped to repeat its success of investing in the personal computer market when it bought the PC division of IBM back in 2005. In 2013, Lenovo overtook HP to become the world's largest maker of personal computers. It is important to remember that investment does not guarantee profit in the future; Google lost more than $9bn in the deal with Lenovo as it had bought Motorola for $12.5bn in 2011.

How investment is financed also affects the cash flow position of a business. Diversified companies with a broad product portfolio (see Chapter 27) can rely on alternative revenue streams (see Chapter 16) to improve their cash flow position. For example, Microsoft bought Skype for $8.5bn in 2011 in a deal worth 32 times larger than Skype's operating profits at the time. However, the software giant simply relied on its strong cash flow position from its broad product portfolio of over 100 other companies it had already acquired. Another cash-rich company is Facebook (Meta), which bought Instagram for $1 billion in 2012, Oculus for $2 billion in 2018 and WhatsApp for a staggering $19.3 billion in 2014.

Good cash flow management is vital for investment opportunities because poor cash flow results in missed opportunities for capital expenditure that can help the business to be more competitive and profitable in the future. The pharmaceutical industry is an example - it can quite easily take around 17 years to commercialize a drug to the mass market. Effective cash flow management and product portfolio management (see Chapter 27) are therefore necessary prerequisites before a business can turn an investment into profit for its owners.

Case study 20.3 - Amazon

Amazon was founded by Jeff Bezos in 1994 in Seattle, USA. Initially, the e-commerce company had forecast that it would take up to 5 years to return a profit to its investors. It was not until 2001 that Amazon finally earned a profit of $5m on sales revenue of over $1 billion. Today, its annual sales revenue is in excess of $387bn with good cash flow and profit. Jeff Bezos is one of the world's wealthiest people alive.

Common mistake

Many students seem to think that a positive cash flow figure means that a business is profitable. This shows a lack of clear understanding as the profit and loss account (see Chapter 17) is used to show whether a business is profitable.

Theory of Knowledge (TOK)

Cash flow forecasts are presented in a summary format, without details of each and every item of cash inflow and cash outflow. Does this simplification limit our knowledge of financial matters in business organizations?

Strategies for dealing with cash flow problems (AO3)

All businesses must have healthy cash flow in order to pay their staff, suppliers, financiers and landlords. The main causes of cash flow problems include:

- **Overtrading** - This situation occurs when a business attempts to expand too quickly (or aggressively) without the sufficient resources to do so. For example, the business accepts more orders than it has the capacity to handle. The excess orders add to production costs without any corresponding revenue (which only comes after the product has been manufactured and sold to customers). The purchase of fixed assets (investment expenditure) as part of a firm's rapid expansion consumes cash, thus reducing the next cash flow of the business.

- **Over borrowing** - The larger the proportion of capital raised through external sources of finance (see Chapter 15), the higher the cash outflow on interest payments for loan capital. During times of rising interest rates, the cash outflow on loan interest increases, putting further pressure on a firm's net cash flow and liquidity position.

- **Overstocking** - This means that a business holds too much stock (inventory) as a result of ineffective stock control (see Chapter 40). Stocks cost money to buy, produce and store. Stocks are also prone to damage and may expire or become obsolete (outdated) before they are even sold. In addition, excess stocks represent a waste of scarce resources as the money could have been better spent elsewhere.

- **Poor credit control** - Cash flow problems can arise when a firm offers customers a prolonged credit period (perhaps to gain a competitive advantage), leading the business to trade for extended periods without sufficient cash inflows. **Credit control** is the process of monitoring and managing debtors, such as ensuring only suitable customers are given trade credit and that customers do not exceed the agreed credit period. Poor credit control arises if too many customers are offered credit, which increases the chances of bad debts being experienced **Bad debts** exist when debtors are unable to pay their outstanding invoices (bills), which reduces the cash inflows of the vendor (the business that has sold the products on credit).

- **Unforeseen changes** - Unexpected and erratic changes in demand can cause serious cash flow problems. Machinery breakdown is one example as this delays receipt of payments from customers. Conversely, seasonal fluctuations in demand for certain products cause temporary, albeit perhaps somewhat predictable, cash flow issues. This affects businesses that face highly seasonal demand, such as producers of Valentine's cards, Easter eggs, Halloween products and 'Back to School' products such as stationery and textbooks.



Figure 20.1 - Seasonal demand causes fluctuations in cash flow

Strategies for dealing with cash flow problems require effective financial management. This means the business must successfully manage its current assets (cash, debtors and stocks) and its current liabilities (bank overdrafts, trade creditors and short-term loans), as explained in Chapter 17. Quite often, the solution to a problem is to deal directly with its cause(s). Hence, there are three generic ways for dealing with cash flow problems:

- Reducing cash outflows
- Improving cash inflows
- Obtaining additional sources of finance.

Question 20.5 - Bereti's Boutique

Nicole Bereti is planning to open a perfume boutique in Vancouver, Canada, which will commence business at the beginning of August this year. Examine the following information and then answer the questions that follow.

- Nicole has $15,000 of **personal funds** that she wishes to use for her business in August.
- She estimates that sales revenue for the first four months will be: $5,000, $5,800, $7,000 and $9,500.
- The cost of buying the perfumes is estimated to be: $3,000, $3,480, $3,850 and $4,750 respectively.
- Anticipated expenditure on advertising is $1,500 for the first month and $1,000 every month thereafter.
- Nicole intends to hire four members of staff, who will each earn a **salary** of $1,200 per month.
- Other costs (such as rent and utility bills) amount to an average of $600 per month.

	Aug ($)	Sept ($)	Oct ($)	Nov ($)
Opening balance				
Owner's capital				
Cash inflows (sales)				
Total cash inflows				
Cash outflows:				
Cost of sales				
Advertising costs				
Staffing costs				
Other costs				
Total cash outflows				
Closing bank balance				

(a) Define the term *personal funds*. *[2 marks]*

(b) Define the term *salary*. *[2 marks]*

(c) Complete the cash flow forecast for Bereti's Boutique in the table above. *[5 marks]*

(d) Examine the cash flow position faced by Bereti's Boutique. *[6 marks]*

(i) Reducing cash outflows

These methods of improving the cash flow position of a business involve reducing costs and/or delaying the payment of costs. Examples of such strategies include the following:

- **Seek preferential credit terms** - A business may be able to negotiate extended credit terms, i.e. to lengthen the time taken to pay its suppliers and creditors. Alternatively, it can seek alternative creditors who are able to offer preferential credit terms. A limitation with this approach is the administrative costs and the time needed to investigate and negotiate better deals, which might not result in significant differences to the cash flow position of the business.
- **Seek alternative suppliers** - Different suppliers may be able to offer more competitive prices, which would help to reduce their cash outflows. However, cheaper raw materials and stocks (inventories) could equate to lower quality, so the business might need to change its marketing and corporate strategies as a result of this.
- **Better stock control** - Reducing stock levels by using a just-in-time system (see Chapter 37) can help to reduce liquidity being tied up in stocks. This method works well for manufacturers of mass market products such as motor vehicles and consumer electronics. However, it might not work as well for businesses that offer a service (such as

airline carriers) or firms that do not hold much stock (such as hair salons).

- **Leasing** - Leasing, rather than purchasing, reduces the burden on cash flows. Buying land, machinery, vehicles and capital equipment will clearly be more expensive than renting or leasing (see Chapter 15), at least in the short term.

- **Reduce expenses** - Scrutinising expenses can help to identify overhead costs that can be reduced, without compromising quality. For example, major airlines have saved huge amounts of money by reducing the number of drinks and snacks that are available on economy class air travel. Some costs might not be necessary at all, including extravagant (non-essential) expenses for senior executives such as luxury company cars.



Figure 20.2 - Cutting extravagant expenses such as luxury cars for directors improves cash flow

(ii) Improving cash inflows

These methods of improving the cash flow position of a business involve increasing the amount of cash coming into the organization. Examples of such strategies include the following:

- **Tighter credit control** - Firms can limit trade credit to their customers or reduce the credit period. Both methods mean that the business receives cash sooner which helps to improve its cash flow. However, customers might switch to competitors due to the worsened trade credit terms. Alternatively, debtors can be encouraged to pay earlier or on time by offering incentives, such as price discounts. Accepting interim payments can also help.

- **Cash payments only** - Requiring customers to pay by cash removes the delay in receiving cash from credit sales. However, the drawback is that customers might prefer to buy from competitors who offer preferential trade credit. After all, if business customers paid by cash, this could negatively affect their own cash flow position.

- **Change pricing policy** - Cutting prices can help to convert excess stocks into cash. In addition, it can help to offload excess stocks. This tactic works best for products that are highly price elastic (see Chapter 28) because they have lots of substitutes or are at the end of their product life cycle (see Chapter 27).

- **Improved product portfolio** - By providing a wide and varied product portfolio (see Chapter 27), a business is more likely to generate increased sales revenue. Poor sales in one product market can be offset by higher sales in other markets. Limitations are that broadening the product portfolio raises costs and risks, yet does not guarantee positive net cash flows.

Case study 20.4 - Agnès B

Agnès B, the French fashion design label, has diversified its product portfolio to gain more revenue streams and improved net cash flows. Its product portfolio includes clothing, fashion accessories, shoes, handbags, chocolates, patisserie products and fresh flowers.

(iii) Obtaining additional sources of finance

These methods of improving the cash flow position of a business involve the use of additional sources of finance, usually from external sources. Examples of such strategies include the following:

- **Overdrafts** - Banks provide this service which allows a business to temporarily take out more money than exists in its bank account. This gives the firm immediate access to cash during times of negative net cash flow. However, the firm needs to pay interest on the amount that has been overdrawn, which can be rather expensive. Firms facing a liquidity crisis might also find it difficult to obtain an overdraft due to the financial risks to the lender.

- **Selling fixed assets** - The sale of dormant assets (obsolete or unused assets) can generate much-needed cash,

although it is only a one-off (as the asset cannot be resold by the business). However, selling fixed assets is not usually advisable, unless totally unavoidable, as these are needed for a business to operate and to expand.

- **Debt factoring** - This financial service involves an external party taking over the collection of money owed by debtors. The debt factoring provider passes on the money owed to its client (minus the handling charges), thus giving the business immediate access to cash.

- **Government assistance** - Some businesses qualify for grants, subsidies or low-interest loans. This helps to boost the cash flow position of a business. Governments are often reluctant to ignore struggling businesses, especially those in strategic industries, as this could lead to major job losses and higher social welfare costs.

Case study 20.5 - Arsenal Football Club

In July 2019, Adidas became Arsenal Football Club's new shirt sponsor in a £60 million ($84 million) per year deal, with the cash injection helping to boost the English Premier League club's ability to compete in the most lucrative sports league in the world. Manchester United Football Club also have a shirt sponsorship deal with Adidas, worth £75m ($105m) a year.

Arsenal Football Club also have a sponsorship deal worth £40 million ($56m) a year with Emirates, with the club's shirts displaying the sponsor's slogan 'Emirates - Fly Better'. The London football club was previously associated with Puma and had a 20-year association with Nike.

Table 20.2 - Summary of strategies for dealing with cash flow problems

Lower cash outflows	Raise cash inflows	Additional finance
Preferential credit terms	Tighter credit control	Overdrafts
Seek alternative suppliers	Cash payments only	Sale of fixed assets
Better stock control	Change pricing policy	Debt factoring
Reduce unnecessary expenses	Broaden product portfolio	Government assistance
Leasing or renting		

However, managers face a dilemma in balancing the conflict between the desire for sufficient liquidity (positive net cash flows) and the desire for profits. Larger profits can be earned by granting credit to more customers, to encourage them to buy. Since credit incurs administrative charges, many retailers require customers to spend a minimum amount before they can benefit from offering credit to customers. However, credit will prolong the firm's receipt of cash. By contrast, only accepting cash payments will ultimately drive away many customers. Striking the right balance will depend on the organizational culture, customer expectations and the actions of competitors. For example, increased competition in a globalized and digitized world has led customers to expect credit. It is also expected for purchases of expensive consumer durables such as jewellery, motor vehicles and home furniture. Without offering credit, many customers will be deterred.

In reality, businesses are likely to use a combination of cash-boosting and cost-reducing methods to improve their cash flow. The Pareto Principle (or the 80-20 Rule) suggests that forward-looking businesses ought to focus 80% of their time and resources to boosting cash inflows and only 20% on cost-cutting strategies.

Exam tip !

Note: as cash flow forecasts and cash flow statements do not show the profitability of a business, the above strategies are based purely on cash flow problems (rather than profitability problems). Instead, the profitability of a firm can be seen in its profit and loss account (see Chapter 17) and via ratio analysis (see Chapters 18 and 19).

Exam tip !

Watch out for credit sales! When dealing with credit sales, be aware that the cash from such transactions is not received until the end of the credit period. For example, if $10,000 of goods were sold in July with 30 days credit, then the cash for this is not received until August. Hence, the $10,000 cash inflow is recorded in August (not July) in the cash flow statement.

Question 20.6 - Ducie's Dance Studios Ltd.

Marj Ducie runs a profitable dance company. However, she is concerned about the latest **cash flow forecast** for the business. She has used the following data to prepare a cash flow forecast:

- Sales revenue are $12,000 in March, $10,000 in April, $9,000 in May and $11,000 in June.
- Payments from customers are 50% paid for in cash and 50% paid for on one month's credit.
- Direct costs are $5,500 in April, $4,950 in May and $6,100 in June.
- Indirect costs are $5,000 each month.
- The opening cash balance in April is $1,000.



(a) Define the term *cash flow forecast*. *[2 marks]*

(b) Outline a possible reason why profitable firms like Ducie's Dance Studios Ltd. might experience cash flow problems. *[2 marks]*

(c) Construct a cash flow forecast for Ducie's Dance Studios Ltd. for the period April to June. *[5 marks]*

(d) Examine the options available to Ducie's Dance Studios Ltd. in dealing with the its cash flow problems. *[6 marks]*

However, the above strategies for dealing with cash flow problems do not always work. Cash flow forecasting as a management tool has its limitations. Movie mogul Sam Goldwyn (1879 - 1974) once joked that making predictions is difficult, especially if it concerns the future. Cash flow forecasting attempts to predict the liquidity position of a business in the future, based on certain assumptions. Inaccuracies can occur due to a number of reasons, such as:

- *Marketing* - Inaccurate or poor market research can lead to incorrect sales forecasts (see Chapter 25). A distasteful or unappealing marketing campaign could upset customers, thereby also harming the firm's cash flow position.
- *Human resources* - A demoralised workforce becomes a less productive workforce that delivers poor customer service. Disputes that are not managed well can lead to industrial unrest (see Chapter 13). The result of unmanaged conflicts will be an unfavourable impact on the firm's cash flow position.
- *Operations management* - Machine failure and poor stock control (see Chapter 40) can cause production delays to the detriment of the firm's cash flow.

Case study 20.6 - Airbus

Initial production delays to the Airbus A380 (the world's largest passenger aircraft) caused Airbus to pay out huge sums of compensation to its customers such as Singapore Airlines and Emirates. This subsequently forced the break-even level of sales of the A380 to increase by almost 70%. Ongoing cash flow problems caused Airbus to end production of the A380 in December 2021.

- **Competitors** - The behaviour of rival firms can be difficult to anticipate yet is likely to directly affect a firm's cash flow position and its level of success. For example, Toyota's aggressive but appealing marketing in the USA has threatened the sales and cash flow of American car makers such as General Motors, Ford and Chrysler.

- **Changing fashion and tastes** - A favourable change in demand for a product means that actual cash flows will be higher than originally forecast and vice versa. Some products may become unpredictably popular, so this would boost their cash inflow.

- **Economic change** - Changes in economic factors can also present opportunities or threats (see Chapter 46), thereby impacting a firm's cash flows. For instance, lower interest rates tend to encourage borrowing which boosts consumer spending and business investment expenditure. Over time, this should increase employment and stimulate economic growth, thus boosting sales and net cash flows. By contrast, higher rates of inflation (when the general price level in the economy rises) can harm both consumer and producer confidence, possibly leading to an economic downturn.

- **External shocks** - Events such as wars, oil crises, stock market crashes, health scares or severe adverse weather conditions will make initial cash flow forecasts less accurate.



Figure 20.3 - Severe adverse weather can cause cash flow problems for businesses

Finally, it is important to know that there are no guarantees that predictions and assumptions made in a cash flow forecast will materialise. This is why such forecasts tend to be for the immediate and foreseeable future only because predictions of the distant future are likely to be highly inaccurate and therefore rather meaningless. Cash flow forecasting is also a continuous, ongoing process with regular adjustments being made when necessary. This helps to ensure that the cash flow position of a business is carefully monitored to identify potential problems before they occur. Ultimately, the usefulness of any cash flow forecast depends on how well prepared and accurate the estimates are.

Theory of Knowledge (TOK)

To what extent do cash flow statements reveal the 'truth' about a business?

ATL Activity (Research skills)

Investigate the cash flow position for an organization of your choice. You may, for example, be able to speak to your school Business Manager (Bursar or Financial Administrator). Based on your findings, comment on the cash flow position of the organization.

Cash flow and the key concepts

Effective cash flow management is important to all businesses, despite the challenges presented by continual changes in the internal and external environments (see Chapter 46). Firms are also likely to have a contingency fund which sets aside cash for unexpected changes and emergency use (see Chapter 41). The greater the level of uncertainty faced by a business and the more exposed it is to change, the higher its contingency fund tends to be and the more attention it needs to pay to effective cash flow management.

Financial difficulties, caused by poor cash flow management, will bring about problems for employees, customers, suppliers and investors of the business. These problems can threaten the survival and sustainability of the organization. A business needs sufficient cash flow for all aspects of its business strategy. For example:

- Human resources strategy - Sufficient cash flow is needed to pay employees on time. Motivation theory (see Chapter 10) suggests that pay is a key motivator for many people. Indeed, a lack of pay is seen as a demotivator and can lead to industrial disputes (see Chapter 13). Hence, insufficient net cash flow can lead to a demoralised and an unproductive workforce. Therefore, businesses have

an ethical obligation to ensure there is active and effective cash flow management.

- Marketing strategy - Creative marketing mix activities (see Chapters 27 - 33), such as new product development or extension strategies, require sufficient funding. Only the largest companies can afford to advertise via the mass media such as television and national newspapers. Marketing activities can be funded from products known as cash cows (see Chapter 47), which generate a large and regular stream of cash for the business.

- Production strategy - Manufacturers with long working capital cycles, such as producers of luxury yachts or construction companies, need huge amounts of cash to complete their projects. The **working capital cycle** refers to the time interval between cash outflows for costs of production and cash inflows from customers who receive their finished goods and services. Adverse changes during this time frame can jeopardize the operations of the business. Similarly, cash is also required to pay suppliers so that the supply chain process is efficient (see Chapter 40).

Cash flow forecasting can be an effective management tool to oversee and control a firm's finances. However, the forecasts and calculations are static, i.e., they only represent the cash flow situation of a business at one point in time. Changes in the external environment will alter cash flows, perhaps in a detrimental way. Hence, the results of any cash flow forecast to aid business strategy must be treated with some caution. Indeed, forecasts should be updated regularly to ensure that decision-making is based on the most up to date and relevant information. To ensure the sustainability of the organization, it is critical that the business has sufficient liquidity to meet its costs and current liabilities, such as the money owed to suppliers, financiers and tax authorities.

In summary, given the changing business environment, cash is regarded as being more important than profit in the short term. Profitable firms will not survive in the long run if they are unable to sustain positive net cash flows. There is no doubt that profit is vital and that it leads to the long-term prosperity and sustainability of a business. However, cash flow problems can occur at any time due to changes in both the internal and external environments, thereby causing huge disruptions to even the most established and globalized businesses.

Key concept

With reference to an organization of your choice, discuss how **creativity** and **ethics** have influenced its use of finance.

Business Management Toolkit

Discuss how the inclusion of a cash flow forecast helps to improve the contents of a business plan see Chapter 48).

REVIEW QUESTIONS

1. What is cash?
2. How does cash differ from profits?
3. Why might a profitable business lack cash, whilst a business with cash might lack profit?
4. What is a cash flow forecast?
5. How is net cash flow calculated?
6. What are the main reasons for cash flow forecasts?
7. How does a cash flow forecast differ from a cash flow statement?
8. How does a firm's closing balance relate to its opening balance in a cash flow forecast?
9. What is the relationship between investment, profit and cash flow?
10. What are the main causes of cash flow problems?
11. How does reducing cash outflows help to improve a firm's cash flow position?
12. How does improving cash inflows help to improve a firm's cash flow position?
13. How does obtaining additional sources of finance help to improve a firm's cash flow position?

14. What are the main imitations of cash flow forecasting?

15. How might financial difficulties threaten the survival of a business?

KEY TERMS

Bad debts exist when debtors are unable to pay their outstanding invoices (bills), which reduces the cash inflows of the vendor (the firm that has sold the products on credit).

Cash is a current asset and represents the actual money a business has. It can exist in the form of *cash in hand* (cash held in the business) or *cash at bank* (cash held in a bank account).

Cash flow refers to the transfer or movement of money into and out of an organization.

A **cash flow forecast** is a financial tool used to show the expected movement of cash into and out of a business, for a given period of time.

A **cash flow statement** is the financial document that records the actual cash inflows and cash outflows of a business during a specified trading period, usually 12 months.

Cash inflows refer to the cash that comes into a business during a given time period, usually from sales revenue when customers pay for the products that they have purchased.

Cash outflows refer to cash that leaves a business during a given time period, such as when invoices or bills have to be paid.

The **closing balance** refers the amount of cash left in a business at the end of each trading period, as shown in its cash flow forecast or statement. It is calculated using the formula: Closing balance = Opening balance + Net cash flow.

Credit control is the process of monitoring and managing debtors, such as ensuring only suitable customers are permitted trade credit and that customers do not exceed the agreed credit period.

Net cash flow refers to the difference between a firm's cash inflows and cash outflows for a given time period, usually per month.

The **opening balance** refers the value of cash in a business at the beginning of a trading period, as shown in its cash flow forecast or cash flow statement. It is equal to the closing balance in the previous month.

Overtrading occurs when a business attempts to expand too quickly without the sufficient resources to do so, usually by accepting too many orders, thus harming its cash flow.

Profit in its simplest form is the positive difference between a firm's total sales revenue and its total costs of production for a given time period.

The **working capital cycle** refers to the time between cash outflows for production costs and cash inflows from customers who pay upon receipt of their finished goods and services.



Figure 20.4 - Mobile caterers rely on a short working capital cycle

Chapter 21

Unit 3.8 - Investment appraisal

"Never let a poor man advise you on investments."
- Spanish Proverb

Contents

3.8 Investment appraisal	
SL/HL content	**Depth of teaching**
Investment opportunities using payback period and average rate of return (ARR)	AO3, AO4
HL content	**Depth of teaching**
Investment opportunities using NPV	AO3, AO4

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Payback Period (AO3, AO4)

Investment opportunities using payback period. AO3, AO4
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Investment refers to the purchase of an asset with the potential to yield future financial benefits, such as upgrading computer equipment or the purchase of a building. With most investments, resources are risked in a decision that might or might not bring about future financial gains (see Box 21.1).

Investment appraisal refers to the quantitative techniques used to calculate the financial costs and benefits of an investment decision. It refers to the different methods used to assess the risks involved in investment decision-making. The three main methods of investment appraisal are: the payback period, the average rate of return and the net present value (HL only).

Box 21.1 - The business of Hollywood movies

- The movie *The 13th Warrior* starring Antonio Banderas and produced by Touchstone Pictures cost around $160 million to produce in 1999 but proved to be a huge failure as world box office sales totalled only $61.7 million.
- By contrast, *Avatar* (which cost 20th Century Fox almost $500m to produce in 2009) was a major success; it took just three weeks to reach break-even and overtook Titanic to set a new world box office sales record of over $2.78bn.
- In June 2015, Universal Studios' *Jurassic World* earned a record $511.8 million in global sales during its first weekend around the world - the movie was budgeted at $150 million, so, the return on investment was 341.2% in a single weekend!

Payback period (AO3, AO4)

Investment opportunities using payback period. AO3, AO4

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The **payback period** (PBP) refers to the amount of time needed for an investment project to earn enough profits to repay the initial cost of the investment. The formula for calculating the PBP is:

$$\frac{\textbf{Initial investment cost (\$)}}{\textbf{Contribution per month (\$)}}$$

For example, suppose a firm is considering the purchase of new photocopier equipment at a cost of $10,000. The anticipated financial gain is $6,000 of revenue per year after maintenance costs are paid for. Hence the payback period would be:

$$\frac{\text{\$10,000 for purchase}}{(\text{\$6,000} \div 12 \text{ months})}$$

$$= \textbf{20 months}$$

Most investment projects would only be considered if they have a relatively short PBP. In the above example, 20 months (or 1 year and 8 months) might be acceptable. In any case, the business will not want to purchase the photocopying equipment if it becomes obsolete before the payback period. The advantages and disadvantages of the PBP are outlined in Table 21.1.

CORE

In reality, it is unlikely that the contribution will be constant each year as in the below example 21.1. In such cases, the PBP is calculated using the cumulative cash flow method (see the worked example 21.1).

Worked example 21.1

Suppose the construction of a new sports complex costs $1 million and is expected to generate the following net cash flows during the first four years::

Year 1	$200,000
Year 2	$340,000
Year 3	$430,000
Year 4	$430,000

It can be seen that the project will obviously not break even in the first year (the cash outflow was $1 million whereas the net cash flow in Year 1 is only $200,000). By calculating the cumulative cash flow, we get the following figures:

	Net cash inflow	Cumulative cash inflow
Year 1	$200,000	$200,000
Year 2	$340,000	$540,000
Year 3	$430,000	$970,000
Year 4	$360,000	$1,330,000

We can now see that the payback period (for the initial $1 million) occurs in the fourth year (the cumulative cash flow at the end of the third year is only $970,000). So, to work out the PBP:

(1) Calculate the shortfall at the end of Year 3, i.e. $1,000,000 minus $970,000 = $30,000

(2) Calculate the average monthly net cash flow in Year 4, i.e. $360,000 divided by 12 months = $30,000

(3) Divide (1) by (2) to find the number of months, i.e. $30,000 into $30,000 = 1 month

Therefore, the PBP for the sports complex is forecast to be 3 years plus 1 month.

Question 21.1 - Verton Coffee

Elvy Verton is considering whether to spend $30,000 on purchasing new machinery for her coffee shop business. The annual contribution from this investment is forecast to be $8,000. As a small business owner, Elvy is keen for Verton Coffee to have a short **payback period**.



(a) Define the term *payback period.* *[2 marks]*

(b) Calculate the payback period for *Verton Coffee.* *[2 marks]*

(c) Explain why Elvy Verton is keen to have a short payback period. *[4 marks]*

Question 21.2 - Mark Allegro Leasing Co.

Mark Allegro is considering spending $50,000 to purchase new power tools for his leasing company. The expected net cash flow from renting the new power tools to customers over the next 5 years is shown in the table below. Mark is keen to know the payback period before deciding whether to proceed with this investment.

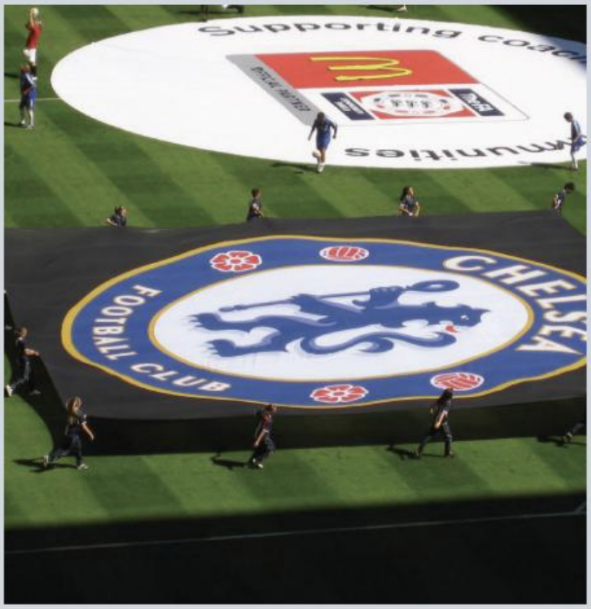
Year	Net cash flow
1	$12,000
2	$14,000
3	$15,000
4	$14,000
5	$12,000

(a) Calculate the payback period for Mark Allegro Leasing Co. *[2 marks]*

(b) Comment on whether Mark Allegro should go ahead with this investment. *[4 marks]*

Question 21.3 - Chelsea Football Club

Chelsea Football Club has enjoyed plenty of title successes since Russian oil tycoon Roman Abramovich took over the sports club in June 2003. He poured in an estimated £440 million ($640m) into the club that year. Chelsea Football Club went on to win the 2004-2005 season for the first time in 50 years.



Abramovich invested a further £240 million ($350m) for the purchase of new players in 2006. However, huge financial losses weighed down Chelsea Football Club, with reported annual losses of £140 million ($203m), £88 million ($128m) and £80 million ($117m) in his first three years as owner of the club.

However, just as Chelsea Football Club had predicted, the investment reached it payback period target in 2010. In 2021, Forbes reported that Chelsea Football Club was the seventh most valuable football club in the world (being valued at $3.2 billion) and earning a profit of $35m with zero debt. In 2022, Roman Abramovich sold Chelsea Football Club for an estimated £3 billion ($4bn).

(a) Identify **two** possible reasons behind Roman Abramovich's decision to buy *Chelsea Football Club*. *[2 marks]*

(b) Explain, using the above case study, why investment can be risky. *[4 marks]*

(c) Comment on the usefulness of the payback period as an investment tool for *Chelsea Football Club*. *[4 marks]*

Table 21.1 - The advantages and disadvantages of the payback period

Advantages of using the PBP	Disadvantages of using the PBP
The PBP is the simplest and quickest method of investment appraisal; hence, it is the most commonly used method.	The contribution per month is unlikely to be constant as demand is prone to seasonal fluctuations so the PBP might take longer.
The PBP method can be useful for firms with cash flow (liquidity) problems as they can identify how long it would take for the cash investment to be recouped.	PBP focuses on time as the key criterion for investment, rather than on profits - the main objective of most private sector businesses.
It allows a business to see whether it can break-even on the purchase of an asset before it needs to be replaced. This can be important in today's fast-paced business environment.	It can encourage a short-termism approach to investment, i.e. managers only focus on the short term benefits and ignore the potential gains in the longer term.
The payback period can be used to compare different investment projects with different costs by calculating the quickest PBP of each option.	PBP might not be highly suitable for some business; property developers and cruise liner operators are unlikely to recoup their investments for many years.
The PBP method helps managers to assess projects that will yield a quick return for shareholders.	Calculations of the PBP are prone to errors as it is difficult to predict future cash flow figures accurately.



Figure 21.1 - It can take many years to recoup the investment costs of a cruise liner

Exam tip !

Students often conclude that because something is 'high risk' or 'risky', a business should avoid it. This is not reflective of the real business world where entrepreneurs have to regularly make decisions that involve a degree of risk. Many businesses have become highly successful by taking huge risks (see Case study 21.1). The decision is not whether to take risks but whether the benefits of the risks are likely to outweigh the costs involved.

Theory of Knowledge (TOK)

What is the definition of time? How much relevance does time have in the study of Business Management?

Case study 21.1

In 2008, multibillionaire Warren Buffett (CEO of Berkshire Hathaway) bought a 10% stake in BYD, an investment worth $230m at the time. BYD, the Chinese manufacturer of automobiles, phone components and rechargeable batteries opened its first manufacturing facilities in the USA in 2014. Its first order in Los Angeles was worth $12.1m for ten zero-emission, all-electric buses. In 2019, BYD opened a bus production plant in Newmarket, Ontario to handle orders in Canada. In 2020, the company opened its third manufacturing plant in Brazil, specifically for producing lithium iron phosphate batteries for use in its electric buses. Today, Berkshire Hathaway owns a 24.6% stake in BYD.

Exam tip !

Probably the biggest potential mistake made by those relying on the use of the payback period is the decision to reject a project simply because it is not expected to pay off quickly, even though it may be very profitable in the long term. Context is important, so consider this when writing your responses.

Average rate of return (ARR) (AO3, AO4)

Investment opportunities using average rate of return (ARR). AO3, AO4

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The **average rate of return** (ARR) calculates the average profit on an investment project expressed as a percentage of the amount invested. The formula for calculating the ARR is:

$$\frac{\text{Total profit during project's lifespan (\$)} \div \text{number of years of project}}{\text{Initial amount invested (\$)}} \times 100$$

Expressed as a percentage, the ARR enables managers to compare the return on different investment projects. As a basic benchmark, the ARR can be compared with the base interest rate in the economy to assess the rewards for the risk involved in an investment. For example, if the ARR of a project for a large established multinational such as McDonald's is 7% whilst the interest rate on savings is 3%, then the real rate of return is 4%. This might well be worth the risk for large multinational companies. However, if it were for a new start-up entering a niche market selling horse saddles, then a 4% real return might not be enough to convince the owner to go into business, especially if banks are offering a (guaranteed) 3% return.

Worked example 21.2



Suppose the purchase of a new computer system that costs $350,000 is forecast to generate the following net cash flows over the next five years (when it needs to be replaced):

Year 1	$100,000
Year 2	$130,000
Year 3	$180,000
Year 4	$150,000
Year 5	$100,000

There are several steps needed to calculate the ARR for this project:

- The total net cash flow over the five years is $660,000
- The forecasted profit = $660,000 minus $350,000 (the cost of the investment) = $310,000
- The average annual profit = $310,000 ÷ 5 years = $62,000 per year
- Hence, the ARR = $62,000 ÷ $350,000 = **17.7%**

Comparing this figure with the base interest rate helps to assess whether the project is worth the risk. If the return on savings is 3.54%, then this particular project seems attractive, as the return on this investment is forecast to be five times greater.

Question 21.4 - DeRogatis Computing Inc.

DeRogatis Computing Inc. is considering whether to invest $100,000 in new machinery. The company expects the annual profits from this **capital expenditure** will be $50,000 per year for 4 years before the machinery needs to be scrapped.

(a) Define the term *capital expenditure.* *[2 marks]*

(b) Calculate the average rate of return (ARR) for DeRogatis Computing Inc. and comment on your findings. *[4 marks]*

The main advantage of the ARR method of investment appraisal is that it enables easy comparisons (in percentage terms) of the estimated returns on different investment projects. For example, if two projects are predicted to yield the same ARR, then the relatively cheaper project might be more desirable given that it carries less financial risk.

However, a weakness of the ARR method is that it ignores the timings of the net cash flows and hence is prone to forecasting errors when considering seasonal factors (see Chapter 25). In addition, the project's useful life span (which might be a pure guess) is needed before any meaningful calculations can be made. Finally, as with all time-based forecasts, errors are more likely the longer the time period under consideration; we might know what is likely to happen tomorrow, but we are less sure about the events in five years from now. No single business back in 2019 could have predicted the devastating impacts of a global pandemic, for example.



Figure 21.2 -COVID-19 had devastating impacts on businesses across the world

CORE

Question 21.5 - Victoria Mayers Holidays Co.

Study the information in the table below for Victoria Mayers Holidays Co. and then answer the questions that follow:

Year	Net cash flow	
	Project Atlanta ($)	Project Boston ($)
0	(140,000)	(140,000)
1	80,000	60,000
2	60,000	60,000
3	20,000	60,000

(a) State the cost of the investment projects under consideration. *[1 mark]*

(b) Calculate the payback period for **both** projects and comment on your findings. *[4 marks]*

(c) (i) Calculate the average rate of return on **both** projects. *[2 marks]*

(ii) Assuming that the savings interest rate is 4.75%, comment on your findings. *[2 marks]*

(d) Explain which investment project is most attractive to Victoria Mayers Holidays Co. *[6 marks]*

Net present value (HL only)

Investment opportunities using net present value (NPV). AO3, AO4

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Suppose you had the option of receiving a university scholarship to the value of $30,000 in either one lump sum today or over a 4-year period. Which would you opt for? Most people would go for the first option rather than the deferred payment option. The reason is linked to the saying '*time is money*'. Money received today can be invested or simply saved in a bank to earn compound interest, whereas money received in the future will have lost some of its value.

For example, if you have $100 and decide to place it into a bank account paying 5% interest, at the end of the year you will have $105. Therefore, $105 received in a year's time is worth the same as $100 received today. If this was saved for a further year, then the present value of $100 received in two years' time would be $110.25 (i.e. $105 plus another 5% interest).



Figure 21.3 - The present value of $105 received in a year's time is $100 if the annual interest rate is 5%

Case study 21.2 - The time value of money

The producers of television reality show *America's Got Talent* have a disclaimer on the $1 million prize money for the winner of the competition. The total prize winnings of $1,000,000 is actually payable in financial annuities over 40 years! That equates to just $25,000 a year for 40 years. If interest rates averaged 5% during this time and after state and federal taxes have been paid, the present value of the prize money is only worth around $375,000 – which is about the cost of a 30-second advert on *America's Got Talent!*

Discounting is the reverse of calculating compound interest. A **discount factor** is used to convert the future net cash flow to its present value today. Given that receiving money today is worth more than it is in the future, the discount factor can represent inflation and/or interest rates. Inflation refers to a rise in the general price level over time. In other words, higher prices in the future will reduce the real value of money received in the future.

As an example, suppose a business expects to receive $100,000 in three years' time whilst today's interest rate is 5%. What is the present value of the $100,000? From Table 21.2, we can see that the discount factor for 5% interest over 3 years is 0.8638. Hence, the present value of the $100,000 received in 3 years' time is $100,000 × 0.8638 = $86,380. This is the equivalent of receiving $86,380 today and leaving it in the bank to earn compound interest of 5% for 3 years, which would equate to $100,000 received at the end of Year 3.

Table 21.2 - Discount factors at different rates of interest

Year	Interest rate									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.9901	0.9804	0.9709	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091
2	0.9803	0.9612	0.9426	0.9246	0.9070	0.8900	0.8734	0.8573	0.8417	0.8264
3	0.9706	0.9423	0.9151	0.8890	0.8638	0.8396	0.8163	0.7938	0.7722	0.7513
4	0.9610	0.9238	0.8885	0.8548	0.8227	0.7921	0.7629	0.7350	0.7084	0.6830
5	0.9515	0.9057	0.8626	0.8219	0.7835	0.7473	0.7130	0.6806	0.6499	0.6209
6	0.9420	0.8880	0.8375	0.7903	0.7462	0.7050	0.6663	0.6302	0.5963	0.5645
7	0.9327	0.8706	0.8131	0.7599	0.7107	0.6651	0.6227	0.5835	0.5470	0.5132
8	0.9235	0.8535	0.7894	0.7307	0.6768	0.6274	0.5820	0.5403	0.5019	0.4665
9	0.9143	0.8368	0.7664	0.7026	0.6446	0.5919	0.5439	0.5002	0.4604	0.4241
10	0.9053	0.8203	0.7441	0.6756	0.6139	0.5584	0.5083	0.4632	0.4224	0.3855

HIGHER LEVEL

Box 21.2 - Calculating discount factors

- Determine the interest rate, e.g. 5%
- Work out the cumulative interest rate, e.g. 5% for 3 years = $(1.05)^3$
- Place this value as the denominator, with 1 as the default numerator, e.g. $1 / (1.05)^3 = 0.8638$ (to 4 d.p.)

Note: You will not be expected to calculate discount factors; discount tables will be given for examination questions. The above is provided for illustrative purposes only.

The net present value (NPV) is the sum of all discounted cash flows minus the cost of the investment project. Money received in the future is worth less than if it were received today, so the longer the time period of the project under consideration, the lower the present value of that future amount of money. The NPV is calculated by using the formula:

NPV = Sum of present values – Cost of investment

The original amount invested is often referred to as the principal or capital outlay. The NPV will be positive (greater than the principal) if the value of the discounted (future) net cash flows are enough to justify the initial cost of the investment. If the NPV is negative, then the investment project is not worth pursuing on financial grounds.

In the following Worked example 21.3, as the NPV has a positive value of $132,940, the investment project should go ahead. However, the business must take care not to over-rely on the NPV method, as the value would be reduced if interest rates were to go up during the next five years. Other limitations are that NPV calculations can be complex and that results are only comparable if the initial investment cost is the same between competing projects

In summary, when assessing the value of investment projects, it is important to consider how the value of money changes over time. Cash received in the future is not of the same value as if it were received today because the money could have been invested to generate financial returns. Inflation also reduces the value of money in the future. So, it is important to calculate the present value of money in order to distinguish between the yields of investments received over different time periods. American poet and philosopher Ralph Waldo Emerson (1803-1882) made this point in his quote that "Money often costs too much."

Worked example 21.3

Suppose that new mechanization for a firm is estimated to cost $300,000 and should last for five years. It will cost an estimated $50,000 per annum to maintain but will increase the value of the firm's output by an estimated $150,000. Interest rates are currently 5%. Calculate the net present value (NPV) on the proposed investment.

Working out *(figures in $)*

The net cash flow in each year is simply the total cash inflow minus the total cash outflow, i.e. $150,000 minus $50,000 = $100,000.

Period	Net cash flow	Discount factor	Present value
Year 1	100,000	0.9524	95,240
Year 2	100,000	0.9070	90,700
Year 3	100,000	0.8638	86,380
Year 4	100,000	0.8227	82,270
Year 5	100,000	0.7835	78,350
Total	500,000		432,940

Notice that although the net cash flow is expected to be the same throughout the life of the project, a sum of $100,000 received in 5 years' time is worth a lot less than the same amount received this year.

Answer: add the total or net present value figures and minus the initial investment cost.

Hence, the NPV = $432,940 – $300,000 = **$132,940**.

Notice that without using the NPV method the estimated return would be much higher at $200,000 (i.e. $500,000 – $300,000). However, the NPV method shows that each of the $100,000 net cash flows received in future years is worth less than the value today. Hence, the real return is only $132,940.

Theory of Knowledge (TOK)

Is there ever a case for a profit-seeking business to pursue a project that has an expected negative net present value?

Question 21.6 - Asvin Bundhun Construction Company

Asvin Bundhun Construction Co. (ABCC) is deciding between two investment projects, codenamed Colorado and Delaware. Both projects cost $300,000. Discount factors for 6% are given to 4 d.p. in the table below.

(a) Calculate the net present value (NPV) of both investment options by completing the table below. *[4 marks]*

Year	Investment Colorado			Investment Delaware		
	Net cash flow ($)	Discount factor	Present value ($)	Net cash flow ($)	Discount factor	Present value ($)
0	(300,000)	1.00		(300,000)	1.00	
1	50,000	0.9434		100,000	0.9434	
2	100,000	0.8900		200,000	0.8900	
3	200,000	0.8396		200,000	0.8396	
4	200,000	0.7921		50,000	0.7921	
NPV						

(b) Based on your calculations, explain which of the two projects should be pursued by ABCC. *[2 marks]*

(c) Explain **two** other factors that *ABCC* should consider before deciding which of the two investment projects the business should pursue. *[4 marks]*

Question 21.7 - Charnley Consulting Company

Study the data below for Charnley Consulting Company (CCC) and answer the questions that follow. The company is deciding between two projects named Adelaide and Brisbane. Each project costs $300,000. Assume that CCC uses an average discount factor of 4%. Refer to Table 21.2 for the relevant discount factors.

Year	Net cash flow	
	Project Adelaide	Project Brisbane
1	100,000	100,000
2	120,000	200,000
3	150,000	150,000
4	200,000	100,000
Total	570,000	550,000

(a) Define the term *net cash flow.* *[2 marks]*

(b) Using relevant investment appraisal methods, recommend which of the above projects would be the most attractive to *CCC.* *[10 marks]*

HIGHER LEVEL

Finance and accounts

Question 21.8 - Puri Garments

Puri Garments (PG) is a manufacturer of fashion garments for well-known retailers in Mumbai, India. It has a labour force of 85 people, most of whom are employed on a part-time basis. Staff retention has been an on-going problem for PG.

The continuous changes in the fashion industry in Mumbai have led PG to devote more of its resources to reducing the time needed to launch new products. Rima Puri, the Director of Operations, is deciding whether to invest in new machinery to improve productivity at PG's factory. The cost of the investment is forecast to be $230,000 with an expected lifespan of four years. The **scrap value** of the machinery is expected to be $10,000.

The estimated net cash flows from the investment are given below:

Year	$'000
0	(230)
1	140
2	180
3	150
4	100

PG uses an 8% discount factor for the cost of capital expenditure. The corresponding discount factors are as follows:

Year 1: 0.9259 Year 2: 0.8573 Year 3: 0.7938 Year 4: 0.7350

(a) Define the term *scrap value*. *[2 marks]*

(b) (i) Calculate the payback period for the proposed investment project. *[2 marks]*

(ii) Calculate the average rate of return on the proposed investment project. *[3 marks]*

(iii) Calculate the net present value of the proposed investment project. *[4 marks]*

(c) Using relevant numerical and non-numerical factors, evaluate whether PG should invest in the new machinery to improve productivity at its factory. *[10 marks]*

Theory of Knowledge (TOK)

To what extent can quantitative investment appraisal support knowledge claims in Business Management?

Common mistake

Make sure you use the correct units of measurement for the different methods of quantitative investment appraisal as marks are often dropped for making careless mistakes:

- The PBP is measured by time, e.g. 2 years and 5 months
- The ARR is expressed as a percentage, e.g. 12.65% and
- The NPV is stated as a monetary value, e.g. $23.65m.

Exam tip !

All students are expected to be able to calculate the payback period and ARR from given data. HL students also need to learn to calculate and interpret the NPV. More importantly though, as this is not an accounting course, you are expected to be able to analyse the results of your calculations and explain the implications for business decision-making.

As with the exercises in this chapter, you may be asked directly to use a method of investment appraisal and calculate these accurately. Finally, you might also be asked to evaluate specified investment options and to recommend which investment option to pursue.

Investment appraisal and the key concepts

Quantitative investment appraisal can be a useful strategic tool as decision-making becomes more objective. Risks are not eliminated but decisions are less prone to inaccuracies and subjectivity. Managers can use such techniques in order to justify their capital expenditure, as part of their overall strategy in response to changes in the internal and external business environments.

Nevertheless, the accuracy of any quantitative investment appraisal is only as good as the quality and reliability of the data used. As implied by the phrase 'Garbage in, garbage out', the use of inaccurate or biased data will reduce the validity of the forecasted calculations. In addition, changes in interest rates will affect the potential net gains of any quantitative investment appraisal. A final point is that investment appraisal may not capture all the relevant costs and benefits, further diminishing the value of such calculations and raising possible ethical questions about the firm's choice of business strategy.

For investments to flourish in a sustainable way, businesses need to have a culture of risk taking, led by creative entrepreneurs. In some countries such as Ethiopia and Bhutan, businesses are risk-averse (where the cultural norm is to avoid risks), whereas American and Singaporean companies are used to promoting entrepreneurial activity. Thus, they are more likely to generate creative ideas and have more productive and profitable businesses despite the risks associated with investments.

However, the investment appraisal methods discussed in this chapter are all quantitative techniques. In reality, change and sustainability do not rely only on numerical data because the calculations do not necessarily reveal the full picture. Qualitative investment appraisal methods that affect investment decisions can be remembered by the mnemonic PORSCHE©:

- **Projections** (gut feelings or instinct) - Investment decisions are often based on managerial intuition regarding change, such as predictions and expectations of changes in interest rates.
- **Objectives** - A profit-seeking business, for example, will prefer to use quantitative methods, but a non-profit organization with strong ethical values may not give numerical analyses such high priority.
- **Risk profile** - Businesses that are risk-adverse (a low risk profile) are less likely to opt for high-risk-high-return investments, choosing instead to pursue lower risk projects with more certainty and returns. This approach protects the business from change, especially if the risks do not pay off.
- **State of the economy** - If the level of business confidence is high, then higher risk projects might be undertaken. However, if interest rates are forecast to rise over the medium to long term, managers become less receptive to implementing change, so put off investment plans.
- **Corporate image** - Organizations need to consider how an investment project might affect their public relations and corporate image. For example, will the attention and response of pressure groups such as Greenpeace be an ethical issue if an investment project goes ahead?
- **Human relations** - All business decisions have an impact on human resources. Managers may need to consider how a particular investment project will change practices in the workplace and hence its impact on staff morale and labour productivity. Decision makers may also need to consider whether automation will cause mass redundancies and, if so, how this needs to be handled.
- **External shocks** - Managers are likely to consider the impact of external influences or events beyond the control of the business (see Chapter 46) when making investment decisions. Events such as adverse weather conditions, oil crises or other natural disasters of unquantifiable risk

will invalidate the results of any quantitative investment appraisal.

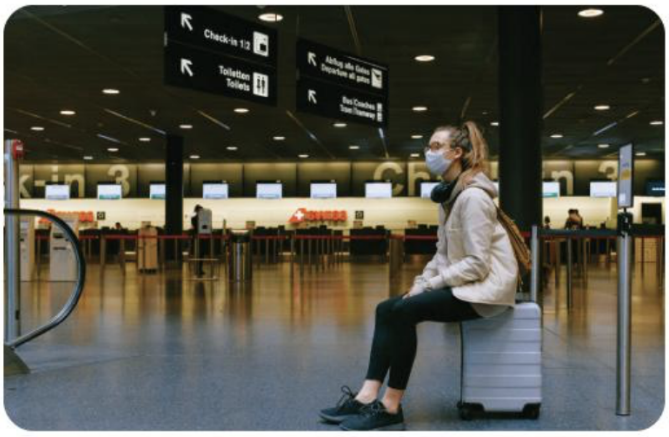

Figure 21.4 - COVID-19 restrictions around the world caused havoc to businesses

In summary, investment decisions are not purely based on numerical calculations. Even if an investment appraisal suggests that a particular project is financially feasible or favourable, qualitative concepts such as ethics and sustainability might be more important in making a final decision (see case study 21.3). Hence, when it comes to strategic investment decisions, it is necessary to consider the wider context and the impact on the various stakeholder groups of the organization.

Business Management Toolkit

How might an understanding of Hofstede's cultural dimensions (see Chapter 54) help managers and entrepreneurs with investment decisions?

Case study 21.3 - Norwich City Football Club

In 2021, the owners of Norwich City Football Club (NCFC) voted against a £5 billion ($7bn) sponsorship deal with BK8, an Asian online gambling company. Although the deal was highly lucrative for the English Premier League football club, it went against the ethical principles of NCFC. Instead, the owners chose to partner with local car producer Lotus Cars. A spokesperson for NCFC said "*Not only is Lotus a local firm but it is clearly trying to do some good, such as its £2.5 billon ($3.5bn) investment to move completely away from petrol and diesel to producing only electric vehicles.*"

Theory of Knowledge (TOK)

Can quantitative investment appraisal ever be free of cultural bias?

Key concept

With reference to an organization of your choice, discuss how **ethics** and **sustainability** have influenced its investment decisions.

REVIEW QUESTIONS

1. What is meant by investment?
2. What is investment appraisal?
3. What is the payback period and how is it calculated?
4. What are the benefits and drawbacks of using the payback period as a method of investment appraisal?
5. What is the average rate of return (ARR) and how is it calculated?
6. What are the benefits and drawbacks of using the ARR method of investment appraisal?
7. What is a discount factor? (HL only)
8. What is net present value (NPV) and how is it calculated? (HL only)
9. What are the advantages and limitations of using NPV as a method of investment appraisal?
10. How does quantitative investment appraisal (PBP, ARR and NPV) differ from qualitative investment appraisal?

KEY TERMS

The **average rate of return** (ARR) calculates the average annual profit of an investment project, expressed as a percentage of the initial amount of money invested.

The **cumulative net cash flow** is the sum of an investment project's net cash flows for a particular year plus the net cash flows of all previous years.

A **discount factor** is the number used to reduce the value of a sum of money received in the future in order to determine its present (current) value.

Discounted cash flow uses a discount factor (the inverse of compound interest) to reduce the value of money received in future years because money loses its value over time.

Investment refers to capital expenditure or the purchase of assets with the potential to yield future financial benefits.

Investment appraisal is a financial decision-making tool that helps managers to determine whether certain investment projects should be undertaken based mainly on quantitative techniques.

Net present value (NPV) calculates the total discounted net cash flows minus the initial cost of an investment project. If the NPV is positive, then the project is viable on financial grounds.

The **payback period** (PBP) is an investment appraisal technique that calculates the length of time it takes to recoup (earn back) the initial expenditure on an investment project.

The **principal** (or **capital outlay**) is the original amount spent on an investment project.

Qualitative investment appraisal refers to judging whether an investment project is worthwhile through non-numerical techniques, such as determining whether the investment is consistent with the corporate culture.

Quantitative investment appraisal refers to judging whether an investment project is worthwhile based on numerical (financial) interpretations, namely the PBP, ARR and NPV methods.

Topic 3: Finance and accounts

Chapter 22
Unit 3.9 - Budgets (HL only)

"If you buy things you don't need, you'll soon be selling things you do."
- Filipino Proverb

Contents

3.9 Budgets (HL only)	
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The importance of budgets and variances in decision-making	AO2

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Cost and profit centres

The difference between cost and profit centres. AO2

The roles of cost and profit centres. AO2

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As a business grows in size, managing its finances becomes more difficult. Costs and revenues from different areas of the business become harder to account for. Hence, different sections of the business are divided up into either cost centres or profit centres with a manager being held responsible for the costs and/or revenues incurred for each division (or centre) of the business.

A **cost centre** is a department or unit of a business that incurs costs but is not involved in earning any profit. These costs are clearly attributed to the activities of that division, such as salaries, wages, lighting, components and capital expenditure. Making these different sections of a business aware and accountable for their contribution towards the organization's costs can help managers to have better cost control. Hence, a manager will be assigned to monitor and manage the expenditure of each cost centre. This allows the business to see which centres are costing the business the most money.

A **profit centre** is a department or unit of a business that incurs both costs and revenues. Profit centres tend to be used by large and diversified businesses that have a broad product portfolio. Again, a manager is responsible for each profit centre, including having to produce an independent profit and loss account. Each profit centre is responsible for contributing to the overall profits of the business. For example, a bank might split its profit centres based on geographical locations. Alternatively, it might be based on the source of revenue, such as private banking, commercial banking, foreign exchange, mortgages, loans, insurance and financial planning. Retailers often do this on a branch-by-branch basis (Starbucks and McDonald's operate profit centres in this way).

Having profit centres allows an organization to identify the areas that generate the most (and least) revenues. Ultimately, improved financial accountability and efficiency lead to improved cost control and therefore higher profits for the

business. Table 22.1 outlines the various advantages and disadvantages of cost and profit centres.

The main roles or functions of cost and profit centres are:

- Organization and control function - Using cost and profit centres enables businesses to have better financial control over all aspects of its operations. They enable businesses to examine and monitor costs and revenues more effectively. Data from cost and profit centres enable managers to compare the financial performance of the different sections of the organization to assess its financial and operational efficiency.

- Autonomy function - Budget holders of cost and profit centres are empowered to make autonomous decisions in the best interest of their particular departments. They are also empowered to make autonomous decisions in a timely manner, without the need to consult with head office, further improving operational efficiency.

- Motivating function - Delegating authority to those in charge of cost and profit centres helps to motivate budget holders to make more informed decisions. The business can reward managers of cost and profit centres who meet or exceed the targets set. Similarly, by giving departmental employees targets and rewarding them for good performance also improves motivation.

- Accountability function - The use of cost and profit centres makes managers accountable for the performance of their teams. They are held accountable for all costs incurred by the cost or profit centre and their capacity to manage these costs. Similarly, budget holders of profit centres are accountable for the amount of costs, revenues and profit or loss made.

Ultimately, the roles or functions of cost and profit centres are to enable large or multi-location businesses to have better financial management and financial performance. Used appropriately, senior managers can use the findings from cost and profit centres to identify high performing divisions of the business and those which need more scrutiny. Cost and profit centres also provide a means of measuring and assessing the performance of employees and rewarding them accordingly.

Table 22.1 - The advantages and disadvantages of cost and profit centre

Advantages	Disadvantages
Managers are forced to be more accountable for their department's contribution towards the organization's costs, especially as the direct costs of production can easily be allocated to cost and profit centres.	Allocating indirect costs (such as rent, insurance and administrative costs) can be a subjective task. Hence, it can be difficult to accurately calculate the overheads attributable to each cost or profit centre.
Managers can identify areas of weakness. It is not always clear if a certain part of a business is making a loss, especially if the organization as a whole is profitable. Using cost and profit centres allows a business to identify loss-making sections or products of the business.	The profits of a department can change simply because of the apportionment of fixed costs (see Chapter 57). Allocating a greater proportion of indirect costs to a particular centre will reduce its profits, although this does not represent its underlying trading position.
Departments and smaller teams tend to work better than larger ones which may suffer from disorganization and a lack of communication. Accountability can promote better team spirit and productivity within the different areas of an organization.	The performance of a division can change due to external factors beyond its control, such as higher raw material prices. This therefore bears no resemblance to the productivity and efficiency of the individual departments of the organization.
There is no need to fuss about whether a cost is fixed, variable, indirect or direct. All costs can be allocated or spread across the various cost and profit centres of the firm.	Data collection is required to accurately account for all costs and revenues of each cost or profit centre, which is likely to be expensive and time consuming.
Benchmarking with the most efficient cost and profit centres within the organization can help to improve the organization's overall efficiency.	Managing cost and profit centres can add to the pressures and burdens on employees. This can lead to motivational and productivity issues.
Delegating budgeting authority to those in charge of cost and profit centres can help to motivate these people. Delegation also helps to speed up decision-making in the organization.	Departments are less likely to consider social responsibilities and ethical objectives if they are run as profit centres. This is because compliance costs reduce their profits.
The performance of cost and profit centres can be used to encourage and reward teams. Teams that achieve their targets and/or operate effectively within their budgets may be rewarded accordingly.	In an attempt to cut costs and/or raise revenues, unnecessary internal competition might result. This can create tension and conflict between the various sections of an organization.

Question 22.1



Kay Edwards is a college student who has plans to visit Manhattan, New York, with her friends in the summer holidays. The total cost of the vacation is expected to be around $500. Kay has a part-time job working in a local supermarket for which she is paid $150 per week. She spends an average of $110 per week, although this is quite flexible. There are ten weeks until the summer holidays.

(a) Determine whether Kay Edwards is likely to be able to afford her overseas holiday. *[4 marks]*

(b) Explain how budgeting can help Kay Edwards in her financial plans. *[4 marks]*

Question 22.2 - Qantas



Qantas is Australia's national flag carrier and has 65% market share of the Australian domestic market. Qantas is an acronym of the airline's original name, Queensland and Northern Territory Aerial Services. It is one of the world's oldest airlines still in operation, having been established in November 1920. As an international carrier, it operates across Africa, the Americas, Asia, Europe and Oceania.

Qantas's operations are varied and include cost and profit centres that are responsible for in-flight entertainment, food catering, members' lounges, its frequent flyer programme (customer loyalty scheme) and Codeshare Agreements (a **strategic alliance** with Oneworld member airlines). It also owns Jetstar, a low-cost airline that operates both domestic and international services. Qantas received the prestigious 'Airline of the Year' in 2021 for the Australia and Pacific region from Skytrax, specialists in commercial air transport research and consultancy.

(a) Define the term *strategic alliance*. *[2 marks]*

(b) Explain why businesses such as Qantas use cost and profit centres. *[4 marks]*

(c) Comment on the likely difficulties involved in allocating Qantas's overheads. *[4 marks]*

HIGHER LEVEL

Exam tip !

It is possible for businesses to operate both profit centres and cost centres. For example, retailers such as Marks & Spencer, 7-Eleven and Zara operate profit centres for each of their outlets, but operate cost centres in their own head office, market research teams and advertising departments.

Constructing a budget (AO2, AO4)

A **budget** is a financial plan of expected revenue and expenditure for an organization or a department within an organization, for a given time period. Budgets can also be stated in terms of financial targets such as planned sales revenues, costs, cash flow or profits. Budgeting is an essential part of managing business organizations. Budgets are also needed when a business grows beyond a certain size that prevents the owner or controller from making all expenditure decisions.

Budgets should be set in line with the aims of the business. They allow resources to be allocated according to the expected level of business activity for a specified period of time, usually one year. This frees up time for senior managers and executives as they do not need to check and authorize all items of expenditure. However, if a budget holder is not operating within the allocated budget, then corrective measures can be taken to improve the situation.

Being a forward-looking financial plan, a budget is prepared in advance, usually on a monthly, quarterly or annual basis. The specific purpose of a budget depends on the type of budget used within an organization (see Box 22.1), although they all serve to help managers plan, monitor and control business activities.

Box 22.1 - Types of budgets

- **Flexible budgets** enable a business to adapt to changes in the business environment. Rapid and sudden unexpected changes will result in actual outcomes being very different from budgeted outcomes.
- **Incremental budgets** add a certain percentage onto the previous year's budget, usually linked to the inflation rate, due to increased costs of production. Expenditure items are more or less the same as before.
- **Marketing budgets** allow managers to plan their marketing activities, such as the amount planned for advertising, sponsorship and sales promotion.
- **Production budgets** are plans for the level of output, including forecasts for the cost of stocks that need to be purchased. Overheads are included to help plan and manage capacity utilization (see Chapter 40).
- **Sales budgets** are forecasts of the planned volume of sales and the value of sales revenue.
- **Staffing budgets** are financial plans of the monetary costs of staff over the next twelve months, such as the number of workers and the cost of labour, including training costs.
- **Zero budgeting** sets each budget holder's account to zero. The budget holder must seek prior approval for any planned expenditure. This helps to identify areas or departments that require large amounts of essential expenditure and those that require less. It also ensures budgets do not grow organically.

In practice, whichever type of budget is used, budgets are consolidated into the overall budget for the organization, known as the **master budget**. The Chief Financial Officer (CFO) has general control and management of the master budget, including financial plans for capital expenditure on noncurrent assets that the business intends to purchase (see Chapter 14).

Bearing in mind the purpose and importance of budgets (covered later in this chapter), there are several considerations when constructing a budget. These include consideration of:

- *The availability of finance* - The greater the financial strength of a business, the greater the budgeted expenditure can be allocated to each budget holder.
- *Historical data* - Budgets are often constructed based on past trends, such as last year's budgeted figures. If economic forecasts are positive, then budgets may be set at a certain percentage above last year's figures.
- *Organizational objectives* - If a business is planning external growth, for example, then budgets need to be raised accordingly as both marketing and production budgets need to be significantly higher.
- *Benchmarking data* - Businesses often set their budgets based on approximating the budgets of their nearest competitors. Therefore, if Cadbury budgets for a $2 million marketing campaign, competitors such as Nestlé and Mars are likely to follow.
- *Negotiations* - Some budgets are set by discussions between budget holders and the Chief Financial Officer or person in charge of the master budget.



Figure 22.1 - Data, such as crime rates, are used to set budgets for police forces

Although there is no universally accepted template for constructing a budget, the template in the IB syllabus is shown below.

All figures in $'000	Budgeted figures	Actual figures
Income:		
Sales revenue		
Interest earned		
Total income		
Expenses:		
Salaries and wages		
Materials		
Rent		
Advertising		
Electricity		
Total expenses		
Net income		

Source: adapted from IB Business Management Guide (2022), page 63

ATL Activity 22.1 (Thinking skills)

With reference to the IB learner profile, discuss whether you think it is better to be principled or open-minded as a budget holder. Be prepared to justify your reasons.

Variances (AO2, AO4)

Budgetary control is the use of corrective measures taken to ensure that actual outcomes equal the budgeted outcomes by systematic monitoring of budgets and investigating the reasons for any variances. A **variance** exists if there is a difference between the budgeted figure and the actual outcome. Budgetary control requires managers to investigate the cause(s) of any variance.

Variance = Actual outcome – Budgeted outcome

Two types of variances can exist:

- **Favourable variances** exist when the discrepancies are financially beneficial to the organization. For example, if actual marketing costs amount to $220,000 but the budgeted value was $250,000, then the business has a favourable variance of $30,000. Alternatively, if sales revenue was

budgeted at $500,000 but the actual sales were $520,000, then there would be a favourable variance of $20,000.

- **Adverse variances** exist when the discrepancies are financially detrimental to the organization. They occur when actual costs are higher than expected (i.e., there is overspending) or when actual revenue is lower than budgeted (i.e., there is underselling).

Budget holders need to investigate the causes of any variance. For example, if an adverse variance is the result of overspending, then senior managers and executives will demand an explanation. There could be valid reasons for this, such as a supplier raising prices significantly after the budget had been set or because the business switched to using better-quality inputs in the production process (which costs more than budgeted).

Exam tip !

There is no such thing as a *positive* or *negative* variance. Mathematically, a 'positive' variance exists when the actual outcome exceeds the planned or budgeted outcome. However, this might not be beneficial if we are referring to production and marketing budgets (as it would mean incurring higher costs than planned). Therefore, for clarity, we only talk about *favourable* and *adverse* variances.

Variance analysis is the management process of comparing planned and actual costs and revenues, in order to measure and compare the degree of budgetary success. It also helps managers to monitor and control budgets. For example, adverse variances provide warnings of falling revenues and/or rising costs. Managers can then implement corrective measures to offset these unfavourable variances. Variance analysis also helps in the review and revision of annual budgets. For example, if there is an adverse variance in the production budget due to rising raw material costs, more funds can then be allocated to the production department.

Consider the data in Table 22.1 which shows the budgeted and actual figures for Sharma Visual Arts Company. It is common practice in variance analysis to use the abbreviations (F) for favourable variances and (A) for adverse variances.

From the table, we can see the following:

- Sales are $5,000 higher than budgeted (planned), so this is financially beneficial to the organization. Hence, there is a favourable variance of $5,000.
- Staffing costs (salaries and wages) were budgeted at $25,000 but the business only spent $23,000 thereby saving $2,000. Hence, there is a favourable variance.
- There is an adverse variance of $3,000 for materials costs as the company planned to spend $15,000 but actually spent $18,000.
- As there is overspending of $2,000 on the advertising budget, this represents an adverse variance for the company.
- Finally, the planned expenditure on rent matches the actual spending on rent, so no variance exists in this instance.

Variances do not have to be expressed in monetary terms. Some businesses prefer to use percentage figures to show discrepancies between budgeted and actual values. For example, the sales variance for Sharma Visual Arts Company is 10% (F) higher than the budgeted figure ($55,000 compared to $50,000). Either way, once variances have been calculated, managers need to investigate the causes and to implement corrective measures. It is common for managers to place greater emphasis on investigating the areas with adverse variances.

Table 22.1 - Variance analysis for Sharma Visual Arts Company, for the period ended 31st March

	Actual value ($)	Budgeted value ($)	Variance
Sales revenue	55,000	50,000	5,000 (F)
Salaries and wages	23,000	25,000	2,000 (F)
Materials	18,000	15,000	3,000 (A)
Advertising	14,000	12,000	2,000 (A)
Rent	20,000	20,000	0

Worked example

Calculate the missing figures in the 'Variance' column and state whether the variance is adverse or favourable. *[5 marks]*

Budget variances for The Wok Express			
	Budgeted figure	**Actual figure ($'000)**	**Variance**
Sales revenue	500	495	
Cost of sales	200	210	
Gross profit	300	285	
Expenses	100	90	
Profit	200	195	

Answer:

Budget variances for The Wok Express			***Answer (1)***	***Answer (2)***
	Budgeted figure ($'000)	**Actual figure ($'000)**	**Variance ($'000)**	**Variance (%)**
Sales revenue	500	495	5 (A)	1% (A)
Cost of sales	200	210	10 (A)	5% (A)
Gross profit	300	285	15 (A)	5% (A)
Expenses	100	90	10 (F)	10% (F)
Profit	200	195	5 (A)	2.5% (A)

Note: for IB assessment purposes, only the absolute figure (rather than the percentage figure) is required. However, the latter technique enables managers to see the scope of variances in the budget.

Question 22.3 - Laptop R Us

(a) Complete the table below for Laptops R Us and identify variances as adverse or favourable. *[5 marks]*

Variable	Budget	Actual	Variance
Sales of laptop A (units)	250	180	
Sales of laptop B (units)	250	260	
Production costs ($'000)	120	150	
Output per worker (units)	20	22	
Labour costs ($'000)	100	115	

(b) Use your answers from above to explain why variances are referred to as favourable or adverse variances rather than as positive or negative variances. *[4 marks]*

(c) Calculate the variance, in financial terms, for each of the cases below. Show all your working.

(i) Laptops R Us had budgeted for $6,000 operating costs in 100 machine hours. However, actual operating costs totalled $5,850 in 100 machine hours. *[2 marks]*

(ii) Laptops R Us had budgeted production of 250 units of Laptop A in 10 machine hours. Variable costs are $100 per machine hour. In fact, 250 units were produced in 8 machine hours. *[3 marks]*

Exam tip !

Although there is not a universally accepted format for presenting budgets, for examination purposes you should stick to the prescribed format from the IB, which applies to both for-profit and non-profit business entities.

All figures in $'000	**Budgeted figures**	**Actual figures**	**Variance**
Income			
Sales revenue	300	320	20 (F)
Interest earned	10	9	1 (A)
Total income	310	329	19 (F)
Expenses:			
Salaries and wages	100	110	10 (A)
Materials	30	32	2 (A)
Rent	20	20	0
Advertising	8	12	4 (A)
Electricity	12	10	2 (F)
Total expenses	170	184	14 (A)
Net income	140	145	5 (F)

Question 22.4 - Quay's Hair Salon Inc.

Dianna Quay's runs a hair salon in Florida, USA. Details of the firm's latest budget are shown below:

Variable	Budgeted ($)	Actual ($)	Variance ($)	Variance (F/A)
Wages	4 000	4 200		
Salaries	4 500	4 500		
Stock	1 800	1 850		
Revenue	15 750		290	Favourable
Direct costs		2 950	250	Favourable

(a) Define the term *budget*. *[2 marks]*

(b) State **two** examples of 'stock' that are likely to be held by Quay's Hair Salon Inc. *[2 marks]*

(c) State **two** specific examples of direct costs likely to be incurred by Quay's Hair Salon Inc. *[2 marks]*

(d) Complete the missing figures in the table above for Quay's Hair Salon Inc. *[4 marks]*

(e) Examine the importance of budgeting to Quay's Hair Salon Inc. *[6 marks]*

Exam tip !

Adverse variances do not necessarily represent a 'bad' situation for a business. For example, an adverse variance on the budgets for production costs or staff budget might simply have been caused by an increase in output to meet an unplanned surge in demand. it is therefore important to look beyond just the numerical data.

Theory of Knowledge (TOK)

Is variance analysis an art or a science?

The importance of budgets and variances in decision-making (AO2)

Budgets and variance analysis are produced for four interrelated reasons: (i) planning and guidance, (ii) coordination, (iii) control and (iv) motivation:

(i) Planning and guidance

Budgeting and variance analysis require managers to plan for the future and to anticipate financial problems before they occur. This should help organizations to be better prepared to overcome problems should they arise. During the planning stage of budgeting, the following questions might be asked:

- How much should the business spend on marketing activities in the forthcoming year?
- How many workers are needed and how much will they cost?
- How much money should be set aside as a contingency fund (for emergency use)?

These questions help to allocate budgets to different departments and divisions (cost and profit centres) of the organization. They can also help to provide some guidance for managers and budget holders in their decision-making.



Figure 22.2 - Budgeting is essential aspect of financial planning

(ii) Coordination

A budget enables managers to control the organization's money, instead of the money controlling the business. Effective budgeting requires managers to match budget allocations with the aims of the organization. For example, the typical budget allocated to the Science and ICT departments in a school is understandably larger than that planned for the Psychology or History departments.

A budget helps the entire workforce to focus on common goals. Without proper budgetary control (any corrective measure taken to ensure that actual performance equals the budgeted performance), budget holders might make decisions that conflict with those made in other departments. For example, the marketing department might unknowingly budget sales revenue beyond the organization's productive capacity (see Chapter 40). Likewise, the production department might budget to expand beyond the firm's financial means. Hence, coordinated and controlled budgeting leads to consistent and transparent decision-making.

(iii) Control

Just as individuals cannot continually live beyond their means (i.e. spend more than they earn), budgeting helps to control business expenditure. Many businesses do not have proper or effective cost control and therefore end up overspending. Without budgeting and variance analysis, managers are not held accountable for their actions and expenditure. This subsequently leads to all sorts of financial and cash flow problems (see Chapter 20).



Figure 22.3 - Budgets help businesses to have better financial control

Budgets and variance analysis are used to ensure businesses have better financial control. Budget holders of cost and profit centres are constrained by what they can do and are held accountable for their spending. Budgetary control and variance analysis help to identify areas where a division is perhaps overspending. Having tighter financial control can prevent a business going into debt, particularly in large organizations that delegate budgets to their middle and senior managers. As part of their performance appraisal (see Chapter 10), budget holders will discuss their budgets with the appraiser (usually the line manager). This provides an opportunity for the budget holder to express any areas of concern.

(iv) Motivational

According to motivational theorists such as Frederick Herzberg (see Chapter 10), recognition, responsibility and employee participation can motivate workers. Delegating budgetary control to budget holders can therefore boost their level of morale as they feel valued and trusted. Involving staff in the budgeting process also helps to promote teamworking (a form of non-financial motivation). This leads to further benefits such as higher productivity and reduced absenteeism.

For businesses, budgetary control can help to allocate and clarify responsibilities. For example, senior managers are placed in charge of larger budgets. It can also be linked to performance management and staff appraisals to recognise and reward those who achieve their performance targets.

Collectively, the four purposes of budgets and various analysis provide benefits that lead to the improved operational efficiency of an organization. Having to work within a realistically set budget encourages managers to seek efficiency gains by drawing attention to wastage and inefficiencies, thereby possibly giving the business a competitive advantage over its rivals. Ultimately, budgets and variance analysis are important as they help senior managers to make more-informed decision-making.

Despite the potential benefits of budgets and variance, there are numerous limitations:

- As with all forms of quantitative forecasts, there may be unforeseen changes that can cause large differences between the budgeted figures and the actual outcomes. This can make some budgets unrealistic and targets unachievable.
- There is a natural tendency for managers to overestimate their budgets because it becomes easier to meet their targets by doing so. However, this can cause complacency as well as wasteful or excessive spending.
- Budgets are not always permitted to be carried forward to the following tax year. This means that any surplus funds do not appear in the subsequent budget. Such practice gives little incentive for budget holders to spend within their budgets.
- Budgets can be set by senior managers who have no direct involvement in the running of the department. This can cause resentment and discontent as senior managers might not fully understand the needs of the department. Ideally, senior managers and budget holders should discuss budgetary needs together before any funds are allocated.
- Whilst budgeting is useful for businesses with stable sales and costs, it is less useful for businesses with seasonal fluctuations in demand and where costs are harder to predict. This is especially the case for businesses that source their materials from overseas (due to fluctuations in exchange rates).
- Rigid and poorly allocated budgets can harm quality. For example, a lower production budget might lead to the use of substandard raw materials and components. Lower quality output will affect sales and could damage the reputation of the business. Similarly, cutting the staffing budget can lead to pay cuts and/or job losses, which creates poor industrial relations (see Chapter 13).
- The process of planning, setting, controlling, monitoring and reviewing budgets can be extremely time-consuming.

- As finances are limited, one department's gain is another's loss. Budget holders compete to increase their own budgets, at the expense of their colleagues responsible for other cost or profit centres. Hence, budgeting can cause conflict in the workplace and perceptions of inequity (unfairness).

- Budgeting and various analysis ignores qualitative factors that affect the financial performance of an organization, such as corporate social responsibilities (see Chapter 3), non-financial motivation of staff (see Chapter 10), brand development (see Chapter 27) and responsibilities towards the natural environment (see Chapter 46).

- The budgeting process is rather inflexible in today's fast-paced and constantly changing business environment. Hence, budgeting can be of limited use as a management tool.

Key concept

Does the budgeting process allow for imagination and **creativity?**

Budgets and the key concepts

Budgeting helps to ensure that managers plan ahead by anticipating the costs and revenues of different business activities in a changing environment. It also involves managers agreeing on priorities and targets. Hence, budgeting has a central role in strategic planning and decision-making to ensure businesses can operate in a sustainable way. Budgeting as an ongoing process is summarised in Figure 22.4.

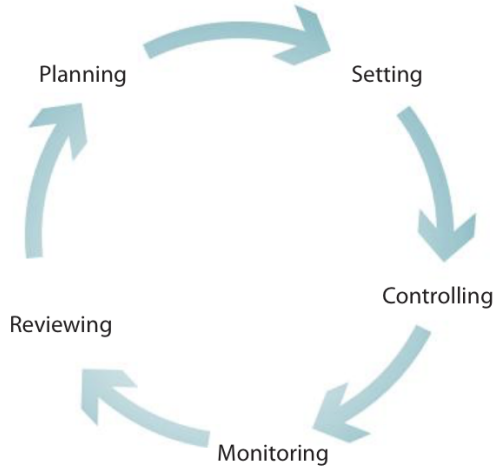

Figure 22.4 - The budgeting process

Since budgets are financial plans used to achieve the strategic goals of the organization in a changing business environment, SMART budgeting requires budgets to be:

- *Specific* - Budgets should be set in line with the strategic vision of the organization.

- *Measurable* - Any budgeting system should ensure that budget holders are held accountable for their successes or shortcomings. Variance analysis can help in this process.

- *Agreed* - For budgeting to work properly, budgets should be set through a process of negotiations and discussions to ensure that appropriate budgets are set.

- *Realistic* - Only realistically set budgets can motivate people to reach the set targets. Under-funding will hinder output, whilst over-funding is likely to lead to complacency, inefficiencies and wastage.

- *Timed constrained* - Since budgets are financial plans for the foreseeable future, there must be a set time constraint. Some businesses allow budget holders to carry forward any unspent funds, whilst other organizations do not encourage this.

During times of change, budgets need to be adjusted to account for strategic and tactical changes. However, unless budgets are changed accordingly, the plans and targets become unrealistic or irrelevant. For instance, if the budgeting process is too rigid, the business will not be in a position to respond to changes in the external environment (see Chapter 46).

Creativity could be hampered if managers become unwilling to take risks that could lead to adverse variances in their budgets. However, creativity can be integral to any growth strategy. Not only are financial plans needed to fund the creativity and growth, but the budgeting process also enables a business to have better cost control as it grows, because costs will clearly increase.

However, budgeting does not come without its problems. For example, sales forecasting (see Chapter 25), which is a prerequisite to setting the sales budget, is only as accurate as the quality of the data used to make the predictions.

Nevertheless, used ethically and correctly, budgets can motivate and empower budget holders, foster responsibility and accountability and aid financial control. Ultimately, effective budgeting avoids inefficient expenditure, thus helping to

enhance the organization's competitive strength and improving its sustainability as an organization.

Business Management Toolkit

Discuss how organizational culture (see Chapter 11) and cultural dimensions (see Chapter 54) can influence the role of budgets and variance analysis in business organizations.

Key concept

With reference to an organization of your choice, discuss how budgeting influences **change** and **sustainability**.

Key concept

Enron was once the seventh largest American company and had been voted by Fortune magazine as the 'most innovative company' for six consecutive years. However, in 2001, the company went bankrupt due to accounting fraud, which left its investors and 20,600 employees with absolutely nothing.

Discuss the role of **ethics** in the budgeting process.

REVIEW QUESTIONS

1. What is a cost centre?
2. What is a profit centre?
3. What are the main roles (functions) of cost and profit centres?
4. What are the main advantages and disadvantages of using cost and profit centres?
5. What is meant by a budget?
6. What are the main considerations when setting budgets?
7. What is budgetary control and why is it important to an organization?
8. What is variance analysis and why is it an important management tool?
9. How do favourable variances differ from adverse variances?
10. What are the main limitations of budgeting?

KEY TERMS

Adverse variances are discrepancies between actual outcomes and budgeted outcomes that are detrimental to an organization, such as production costs being higher than expected.

A **budget** is a financial plan of expected revenue and expenditure for a department or an organization, for a given period of time.

Budgetary control refers to the use of corrective measures taken to ensure that actual outcomes equal the budgeted outcomes, by systematic monitoring of budgets and investigating the reasons for any variances.

A **cost centre** is a department or division of a business that incurs costs that are clearly attributed to the activities of that unit of the organization.

Favourable variances are discrepancies between actual outcomes and budgeted outcomes that benefit an organization, such as sales revenues being higher than expected.

A **profit centre** is a department or divisionof a business that incurs both costs and revenues. Profit centres tend to be used by large and diversified firms that have a broad product range.

Variance refers to any discrepancy between actual outcomes and budgeted outcomes.

Variance analysis is the management process of comparing planned and actual costs and revenues, in order to measure and compare the degree of budgetary success. It also helps managers to monitor and control budgets.

Chapter 23

Unit 4.1 - Introduction to marketing

"The greatest pleasure in life is doing what people say you cannot do."
- Walter Bagehot (1826 - 1877), British journalist

Contents

4.1 Introduction to marketing	
SL/HL content	**Depth of teaching**
Market orientation versus product orientation	AO2
Market share	AO2, AO4
Market growth	AO2, AO4
The importance of market share and market leadership (HL only)	AO3

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CORE

Introduction to marketing

People have different needs and wants. **Needs** are the essential necessities that all humans must have to survive, such as food, shelter, warmth and water. **Wants** are human desires, i.e., things that people would like to have. Irrespective of personal income or wealth, humans have infinite wants. **Marketing** exists to address people's needs and wants. It is about making customers want to buy the products from a particular business. It therefore looks at the reasons behind people's decisions, such as the product's features (e.g., colour, size, quality or special functions) and the price. Meeting the needs and wants of customers is particularly important for businesses aiming to earn a profit.

Legendary reggae songwriter and singer Bob Marley (1945 - 1981) famously said that he did not need a BMW (what he described as an expensive car) as he already had an alternative 'BMW' (Bob Marley and the Wailers). This sums up the challenge facing marketers who must tempt customers to buy their products. Management guru Peter F. Drucker (1909 - 2005) famously said, "*Business has only two functions - marketing and innovation*".



Figure 23.1 - Luxuries are examples of human desires

The marketing department of an organization tends to have four main or generic objectives:

- Ensure that the right **products** are supplied to fulfill the needs and wants of customers.
- Set the correct **price** so that customers can afford to buy the product (and to ensure that they do not buy from a competitor).
- Distribute (or **place**) the products conveniently for customers to buy the product.

- Ensure that there is adequate and effective **promotion** to convince customers to buy the firm's products.

There is no single universally accepted definition of the term marketing because it is a hugely complex process and differs from one type of organization and product to another. For example, the marketing objectives and strategies of charitable and non-profit organizations differ from those of large multinational companies. A widely used and accepted definition is the one provided by the Chartered Institute of Marketing, which defines marketing as:

"The management process involved in identifying, anticipating and satisfying consumer requirements profitably".

This definition is commonly used as it covers the various roles of marketing:

- Marketing is a management process, so it requires people to take responsibility for decision-making.
- Marketing involves identifying the needs and wants of customers. This can be done through market research (see Chapter 26) and management information systems such as data analytics (see Chapter 43).
- Marketing involves anticipating or predicting what customers might need or want in the future. For example, market research and new product development have created markets for laptops, smartphones, electric cars and smart TVs. The movie industry is constantly trying to produce films that audiences might want to see.
- Price, availability and quality are essential factors that customers consider when assessing value for money when they purchase a good or service. Satisfied customers are more likely to become loyal customers.
- Marketing is about earning profit (or a financial surplus for non-profit organizations). Prices must therefore cover the costs of production. Car manufacturers would not use promotions such as 'buy one get one free' as part of their marketing. All organizations must ensure that the benefits of their marketing activities outweigh the costs.



Figure 23.2 - Marketing is vital for the commercial success of all businesses

Market and product orientation

Market orientation versus product orientation. AO2

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Market orientation is a marketing approach used by businesses that are outward looking. They focus on making products that they can sell, rather than selling products that they can make. It focuses on the customer in order to identify, design, develop and supply products that meet their needs and wants. Such information can be gathered from market research (see Chapter 26). For example, the pricing decision is taken after considering information about customers, such as their level of income, as well as the prices charged by competitors. Market research and data analyses are therefore central to a market orientation approach.

If the needs and wants of customers are ignored, businesses are likely to become uncompetitive, with devastating results in the long term. Market orientation means that businesses do not worry about the costs of doing things for the customer; instead, they consider the costs of *not* doing these things. For example, home furniture retailer IKEA provides value added facilities and services to meet the needs of their customers, such as restaurants, adult-supervised play areas for young children (whilst their parents go shopping), changing rooms and free car parking.

The two main advantages to a business in being market orientated are:

- *Greater flexibility* - Businesses can respond quickly to changes in the market as they have access to relevant data and information about customers. Market orientated businesses are also more able to anticipate changing market trends and hence prepare for such changes.

- *Lower risk* - Market orientated businesses can be more confident that their products will sell and be more successful. Decisions based on scientific methods, logic and reasoning tend to be of lower risk. Without proper market research and data analysis, the cost of marketing a product is far more likely to be a gamble.

However, the main disadvantage of market orientation is that market research (needed to find out what customers actually want) can be very expensive. In addition, given the dynamic nature of the business environment and the uncertainty of the future, there is no guarantee that this approach will work.

By contrast, **product orientation** is a marketing approach adopted by businesses that are inward looking. They focus on selling products that they make, rather than making products that they can sell. As Steve Jobs (1955 - 2011), co-founder of Apple, said, "*A lot of times, people don't know what they want until you show it to them.*"

Many hi-tech products that are used in daily life were created using product orientation. Innovative products such as the automobile, television and mobile phone were all 'unknown' to the mass market during their initial launch. Even Henry Ford did not originally realise that the automobile would become a mass market product. One of his most famous quotes was, "A*ny customer can have a car painted any colour that he wants, so long as it is black.*" The Ford Motor Company considered that its offering was good enough for customer back then.

Economists use Say's Law (that supply creates its own demand) to describe how product orientation might be successful. The idea is that creative and innovative products are launched onto the market and customers will be tempted to buy these. For example, Microsoft's Kinect sold 10 million units within 3 months of its launch. Sony sold one million PlayStation 4 games consoles in the USA and Canada within the first 24 hours of its launch. James Cameron's *Avatar* (2009) is the best-selling movie of all time, grossing over $2.847 billion at the box office. Of course, not all products are successful. The usual result is that product orientation is rather hit-and-miss, i.e., without some form of market research, producers are not really sure if their products will actually sell.

For this reason, many product-oriented businesses today concentrate on producing high quality products. The belief is that customers are willing to pay a higher price for exclusivity and luxury products. Product orientated businesses generally supply products that they specialize in, such as Ferrari producing sports cars or Airbus producing commercial aircraft.



Figure 23.3 - Aircraft manufacturers are product-orientated

The main advantages of product orientation are that quality can be assured and the business has more control over its operations. Also, by being innovative, product orientation can give organizations a competitive advantage or a unique selling point (see Chapter 24). For example, Apple gained a USP for its iconic iPhone's 'slide to unlock' technology when the device was launched and revolutionised the way people communicate worldwide.

However, as the needs of the market are ignored (because product orientated organizations assume they know what the market wants), there is a high failure rate of businesses that use this marketing approach. Hence, this strategy tends to be of high risk, especially due to frequent and continual changes in fashion and tastes. The money spent on research and development of products without taking the customer into consideration often proves costly.

Whether a business adopts a product orientated or market orientated approach depends on several factors, including:

- *The market* - Producers of hi-tech products, such as smartphones and electric vehicles, tend to start off as product orientated businesses. In mass consumer markets, a more market orientated approach tends to be adopted.

- *Organizational culture* - Businesses that believe customers are the key stakeholder group (i.e., that customers are always right) are more likely to be market orientated. By contrast organizations that rely on the creative and innovative ideas and designs of their skilled employees may take a more product orientated marketing approach.

- *Barriers to entry* - Businesses without much competition tend to be less customer-focused. Such organizations have market power in pricing and distribution decisions so can choose to be more product-orientated.

Question 23.1 - Sony

Sony Corporation, formerly the market leader in consumer electronics, had built up a reputation of innovation since its beginnings in 1946. However, its complacency during the late 1990s meant that the Japanese company had to play catch-up. Between 2003 to 2005, Sony launched its luxury line of gadgets under the Qualia brand name. This included its $2,400 headphones, $25,700 digital camera and $101,500 audio system

The big problem, however, was that Sony seemed to be more obsessed about the pricey technology than what their **customers** wanted. The Qualia line of high-end products was not well received by customers, especially with the growing competition from the likes of Samsung and Apple. For example, Apple's multimedia devices were outselling Sony's digital music players by a ratio of 5 to 1. Critics argued that Sony had lost touch with its customer base.

(a) Define the term *customers*. *[2 marks]*

(b) Outline why Sony might be described as a 'product-orientated' business. *[2 marks]*

(c) Explain **one** advantage and **two** disadvantages of product orientation to businesses such as Sony. *[6 marks]*

Market share

Market share. AO2, AO4

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CORE

Market share refers to an organization's portion of the total value of sale revenue in a specific industry. It is measured by expressing the organization's sales revenue as a percentage of the total sales revenue in the industry, per time period:

$$\text{Market Share} = \frac{\text{Firm's sales revenue}}{\text{Industry's sales revenue}} \times 100$$

For example, if an organization's annual sales revenues amount to $100 million in an industry with annual sales of $400 million, then its market share is 25%. For example, Amazon accounts for the highest sales revenue in the global smart speaker market, with a market share of over 26%. Google has market share in excess of 93% in the global search engine market.

There is a positive relationship between market share and profits, although the business with the largest market share is not necessarily the most profitable. High market share has other benefits such as the status enjoyed from being a dominant market player and the ability to gain a range of economies of scale (see Chapter 5). These businesses are known as *market leaders*. For example, Nike and Adidas are market leaders in the global sports apparel industry, whilst Coca-Cola is the market leader in the beverages market.

In general, businesses with high market share (market leaders) have better price-setting ability and are less threatened by competition. Hence, a common objective of established businesses is to increase their market share through growth (see Chapter 3). This can be done in a number of ways:

- The promotion of their products to develop brand value and brand loyalty (see Chapter 29).
- Product development, product improvements and innovations (see Chapter 27).
- Motivation and training of the workforce (see Chapter 10) in order to deliver better customer service.
- Establishing intellectual property rights, such as the use of trademarks, copyrights and patents (see Chapter 42).
- Use of more efficient channels of distribution (see Chapter 30).

Question 23.2 - Calculating market share

(a) Complete the missing figures in the table below for a market valued at $250 million. *[4 marks]*

Company	Sales ($m)	Market share (%)
A	80	
B	30	
C		20
D		25

(b) Explain **two** strategies that a business can use to increase its market share. *[4 marks]*

Market growth

Market growth. AO2, AO4

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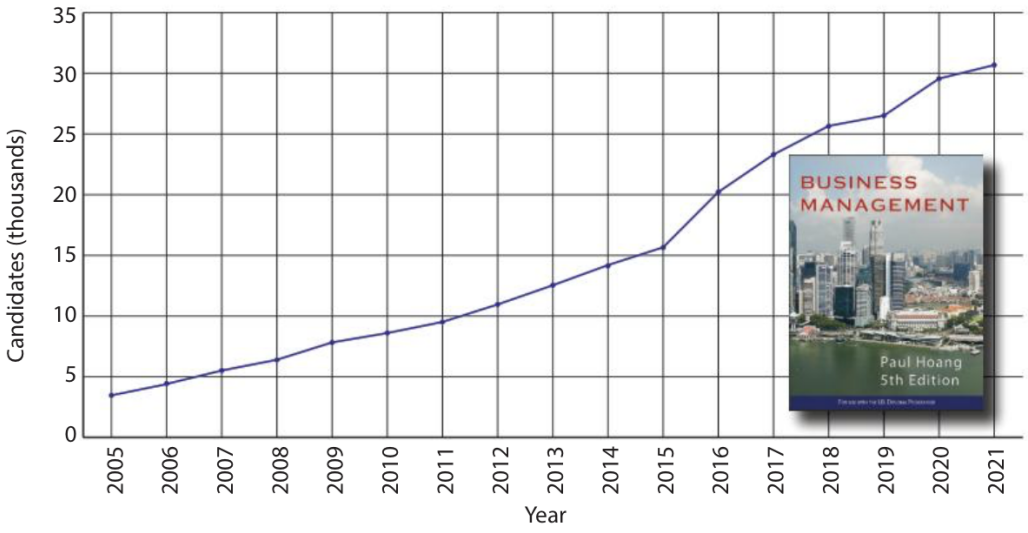
Market growth refers to the rate at which the size of a market is increasing. This is usually expressed as a percentage change in the total sales of the market over a specific period, usually per year. The formula to calculate this is:

$$\text{Market growth rate} = \frac{\text{Current market size} - \text{Original market size (\$)}}{\text{Original market size}} \times 100$$

The market growth rate is an important factor when considering the development or launch of a specific product in a particular market. For example, textbook publishers will enter markets for specific subjects if there is growth in candidate numbers. IBID Press was the first publisher to launch a dedicated textbook for the DP Business Management course (back in 2007), but as the number of candidates taking the course has grown by over 500% since then, several other publishers have entered the market.



Source: IBCA

Figure 23.4 - The growth in IB DP Business Management candidate numbers (2005 - 2021)

Market growth is often used as a measure of the success of a business in relation to its market share. For example, if market growth in an industry is 5% but the firm's market share has increased by 10%, then it is performing significantly better than its average competitor.

Growth is a common business objective (see Chapter 3). Firms strive to recognize and seize opportunities for growth by building on their strengths and core competencies. This also enables the firm to gain higher profits as the market grows, thereby creating value for their owners (shareholders).

It is important to establish customer loyalty to make the most of the opportunities of market growth. Brand loyalty occurs when customers buy the same brand of a product repeatedly over time. Customers are faithful to the brand over other rival brands. Such loyalty not only helps to improve market share and profits but facilitates brand extension strategies (see Chapter 27) for further growth.

Market share and market leadership (HL only)

CORE

The importance of market share and market leadership (HL only).
AO3
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Market leadership refers to the position of a business having the largest market share in a given market for a particular good or service. A market leader can refer to a product, brand or organization so long as it holds the highest percentage of sales revenue in a particular market (see Box 23.1). They dominate the market by being able to have influence with regards to all aspects of marketing, such as pricing, promotion, brand value, quality standards and distribution. Amazon, Apple, Boeing, Coca-Cola, Google, McDonald's and Toyota are all market leaders in their respective markets.

Exam tip !

Be careful with wording your answers in the examinations. In this context, we can use the example of Coca-Cola being the market leader in the global carbonated beverages market as it has more than double the market share of PepsiCo, its nearest rival. Hence, we would say that Coca-Cola is the market leader in the global carbonated beverages industry, while PepsiCo is a market leader.

Box 23.1 - Market domination

Many markets are dominated by a few large firms (the market leaders). How many other companies can you think of, apart from the ones listed, for each of the following consumer markets?

- Sports apparel: Nike, Adidas, Puma and Reebok
- Fast food: McDonald's, Burger King, KFC, Pizza Hut and Subway
- Japanese cars: Toyota, Honda, Nissan and Mazda
- Smartphones: Samsung, Apple, Huawei, Xiaomi and Oppo
- Games consoles: Nintendo, PlayStation and Xbox
- Televisions: Samsung, Sony, Panasonic, LG and Philips
- Search engines: Google, Yahoo! and Bing
- Web browsers: Chrome, Edge, Firefox and Safari
- Soft drinks manufacturers: Coca-Cola Company, PepsiCo and Dr. Pepper Snapple Group
- Toy makers: Lego, Bandai, Mattel and Hasbro.

Market share is one of the most effective ways to measure the success of a business compared to its competitors. When a business has the largest market share in an industry, it shows that the firm's corporate strategy is more successful than that of its competitors.

In reality, most industries within a country are dominated by a few large businesses, each with some degree of market leadership (high market share). Each dominant firm accounts for a large proportion of the industry's overall sales revenues. **Market concentration** measures the degree of competitiveness that exists within a market by calculating the market share of the largest few firms in the industry, i.e., those with market leadership. The sum of these market shares is known as the **concentration ratio**. For example, an industry with a 3-firm concentration ratio of 98% means that the top three firms (the market leaders) have a combined market share of 98%. Hence,

this would not be a very competitive industry, as all other businesses would account for just 2% of the total sales revenue of the industry.

Market leaders enjoy numerous interrelated advantages, which include:

- Premium prices (see Chapter 28) can be charged due to the firm's market leadership status, which increases profit margins.
- Lower production costs exist due to economies of scale as the market leader operates at a larger scale than its rivals in the industry. This means the business has the market power to lower prices, whilst maintaining profit margins, in order to attract even more customers.
- The market leader enjoys longer product life cycles (see Chapter 27) due to the high degree of customer loyalty that exists for the brand or product.
- The market leader benefits from favourable distribution terms as more retailers and intermediaries choose to sell or redistribute the products of well-known and trusted brands (see Chapter 30).
- There is more publicity and brand exposure due to having market leadership status. Market leaders develop a reputation for being the preferred brand of customers and more talked about, leading to further word of mouth promotion (see Chapter 29).
- It can also be easier to attract and recruit highly qualified employees as they feel proud to be associated with the status held by market leaders. For example, Google is consistently ranked as one of the best companies to work for by its employees.

Ultimately, these benefits give market leaders huge competitive advantages. Market leaders will use a range of marketing strategies to maintain their market share and market dominance. This is done by aiming to achieve three interrelated goals:

1. Attracting new customers
2. Increasing repeat purchases from existing customers
3. Diverting customers from competitors (brand switching).



Figure 23.5 - Market leaders benefit from higher sales and profits and lower risks

Nevertheless, being a market leader does add constant pressure for managers and employees to maintain a high standard and to continue to repeat success for the owners (shareholders) of the business. Market challengers will also add pressure as they strive to become the market leader themselves through methods such as aggressive price reductions to attract customers.

Furthermore, calculating market share is not necessarily a straightforward task because it is not always easy to define the industry for a particular good or service. For example, when calculating market share in the transport industry, which modes should be included: road, rail, sea and/or air? What exactly is the market for 'groceries', 'education' or 'healthcare'? Furthermore, sales data are often out-of-date, so any market share information will represent a historical situation and does not necessarily signify the current position.

Business Management Toolkit

With reference to Porter's generic strategies (see Chapter 53), discuss how market leadership enables businesses to gain competitive advantages.

Key concept

With reference to a business organization of your choice, examine why and how marketing strategies evolve in response to **changes** in customer preferences?

Question 23.3 - Samsung versus Apple

Samsung is the world's largest smartphone producer. The South Korean company's global **market share** is above 20% whilst that of Apple (its nearest competitor) is around 15%. Samsung's market dominance has been helped by rising demand for its innovative products. Its market share of the tablet computer industry is approximately 27%, second only to Apple the market leader with over 55% market share.

Samsung's own market research showed that customers wanted technology to help them stay and keep fit. In 2014, Samsung introduced its wearable smartwatch and fitness band products that link to mobile devices, in an attempt to shift the innovation of smartphones from the hand to the wrist for added consumer convenience. The company has market share of around 17% in this industry, behind Apple, the **market leader,** with 34% market share.

(a) Outline how *market share* is calculated. *[2 marks]*

(b) Define the term *market leader.* *[2 marks]*

(c) Examine the importance of market leadership to businesses such as Samsung and Apple. *[6 marks]*

Introduction to marketing and the key concepts

CORE

Marketing is fundamental to the success of a business as it affects the sales and profits of the organization. However, marketing alone does not ensure success nor is it sustainable on its own. Hence, its relationship with other business functions should also be considered in the context of changes in the internal and external business environments:

- **Operations management** - The production department works closely with marketers in using sales forecasts (see Chapter 25) and market research (from Chapter 26) to prepare their production schedules. These departments work directly with each other to research, develop and launch products to meet the changing needs of customers. There may, however, be some conflict between the two departments as production managers may prefer a longer time period in which to create, test and develop products whereas marketing managers may push for a quick launch to maximize sales revenues. Delays in launching a product not only means lost sales but can also be damaging to the organization's corporate image.

- **Finance and accounts** - The marketing department works closely with the finance department to set appropriate budgets. Again, there can be conflict between these departments. For example, marketers might wish larger budgets to get maximum marketing exposure. However, the finance team wants all departments to work within their allocated budgets in order to maintain financial control of the business as a whole. The finance department would want prices to cover costs of production to generate profit. However, marketers might feel that lower prices (that do not necessarily cover all costs) are necessary for some products in the short term to get established in the market. Marketers might also use extended credit terms (such as interest-free repayment plans) to entice customers. However, the finance department will be aware that extended credit can lead to liquidity problems (see Chapter 20). Hence, both departments need to work collaboratively to strike a balance between their potentially conflicting interests.

- **Human resources** (HR) - Marketing data can help the HR department to identify staffing needs. For example, the introduction of a new product might require hiring extra production staff and sales personnel. The HR department's role is to ensure the business has the right quantity and quality of workers through effective workforce planning (see Chapter 7) in order to meet the changing wants and needs of its customers.

Marketing ethics also have a role in an organization's marketing strategies. This refers to the moral aspects of marketing. Unethical marketing practices exists when moral codes of conduct are not adhered to and when such activities cause

offense to members of the general public. For example, *bait and switch* marketing techniques (see Box 23.2) are considered to be unethical in many parts of the world. This is a controversial marketing method used to entice customers by advertising deals that are simply too good to be true. Once customers are hooked onto the deal (the bait), they discover that it is no longer available and change to purchasing another pricier alternative (the switch) from the business. High-pressured sales tactics are used to ensure that targeted customers make the switch. Other examples of unethical marketing techniques include:

- Confusion marketing involves businesses swamping customers with price and product information. Mobile phone subscription plans and bank mortgage deals are examples. Being inundated with a myriad of information prevents customers from making rational or logical choices, so customers lack incentives and information to switch to rival brands or products.
- Fear tactics - the exploitation of people's worries or weaknesses is unethical as it preys on people's vulnerability. This includes pre-empting urgency, such as 'limited stocks only' advertising campaigns.
- 'Get rich quick' schemes that offer people the opportunity to get rich quick with minimal effort. Such schemes often involve terms and conditions that are not made clear to customers, such as participation and membership fees.
- Health fraud - using untested scientific claims to promote a product, such as unsubstantiated promises of overnight medical cures.
- Pester power - using children to harass their parents into buying certain products, like toys, fast food, consumer electronics, family cars and holiday destinations.
- Product misrepresentation - using brand names similar to well-known trademarks and/or using product descriptions that are highly inaccurate.
- Travel fraud - giving misleading information to travellers, such as inaccurate descriptions of hotel facilities with 'sea view' rooms.
- Unsubstantiated claims - marketing claims that cannot be proved, such as 'nine out of 10 tests prove…' or '4 out of 5 people prefer…'

Box 23.2 - Bait & Switch - unethical business practices?

- Airlines advertise cheap flights from $10, when in fact only several seats are available at this price. Once these are sold and quite often to their own staff, the campaign is continued although there are no more seats left at the advertised price. Customers therefore end up paying higher prices.
- Mobile phone retailers advertise a new product, but it is limited in supply or out of stock. Customers end up buying higher priced models instead.
- Real estate firms launch new developments using claims such as 'Apartments from just $349,950' when actually only one apartment is being sold at that price. In fact, it is likely to have already been sold before the advert even got to the printers.

Whether marketers act ethically will depend on the moral principles that are held by the management, the organizational culture (see Chapter 11) and the values of society as a whole. However, determining whether a specific marketing campaign is ethical can often be rather subjective. This is because what is offensive to one person or group of people might not be to another (see ATL Activity 23.1 below).

CORE

Case study 23.1 - Johnson & Johnson

In 2013, pharmaceutical giant Johnson & Johnson was fined more than $2.2bn due to its unethical marketing practices. The US justice department found Johnson & Johnson guilty of paying incentives to doctors and pharmacies who promoted three of the company's medicines. The fine is one of the biggest healthcare fraud settlements in US history.

ATL Activity 23.1 (Thinking and communication skills)

In groups of 2 or 3, discuss the following questions. Be prepared to share your responses with your teacher and others in the class.

- Should marketers be banned from advertising high-sugar and high-energy drinks (such as Coca-Cola, Red Bull and Lucozade)?
- Is it acceptable for airlines, hotels, cinemas and theatres to raise their prices (by using surge pricing) during school holidays?
- Is it acceptable for businesses to use computer games to advertise directly to children?
- Should ambiguous and/or unproven advertising claims be banned?
- Should marketers be allowed to advertise national lottery tickets or should national lotteries be totally outlawed?

The use of unethical marketing, whether deliberate or otherwise, is a high-risk strategy. Misleading or offensive marketing strategies can backfire and make customers boycott the products of a business. Also, governments have been pressured to ensure that the general public is protected from immoral business practices. For example, in most countries advertising activity is carefully monitored by government organizations or regulatory bodies. Therefore, most businesses abide by certain guidelines and rules for ethical marketing (known as an **ethical code of practice**), which help to serve three main functions:

- To identify acceptable business practices (from society's point of view).
- To foster internal management and control.
- To avoid confusion regarding what is and what is not acceptable.

CORE

Marketing

Question 23.4 - Banning pester power

Pester power is a marketing strategy that aims to put pressure on parents by targeting advertisements directly at children. Pester power techniques have been banned in the European Union (EU) since 2007. The EU also prohibits businesses in all member countries from using bait and switch marketing, which it claims is misleading and can upset members of the public.



Children are being increasingly exposed to marketing due to technological advances and a change in lifestyles. In particular, the increasing number of children with smartphones and direct access to the Internet means that marketers have greater opportunities to advertise directly to this potentially vulnerable group of consumers. The rationale behind the EU's consumer protection laws is to force businesses to operate more ethically.

(a) Examine whether it is ethical to market products directly at children. *[6 marks]*

(b) Discuss the effectiveness of marketing campaigns designed to deliberately shock and possibly offend members of the general public. *[10 marks]*

Theory of Knowledge (TOK)

Given the diverse nature of cultures and different standards of business etiquette across the world, can international marketers ever truly know what is ethically right and what is ethically wrong?

Creativity is integral to all aspects of marketing. For example, non-profit organizations do not have the marketing budgets to compete with the likes of large multinational companies that enjoy being market leaders. Hence, NPOs rely on creative strategies to market their cause (mission) in a highly cost-effective way. For example, newsletters are published online and there could be options to make donations using various online platforms. Most for-profit organizations have also adopted the use of creative online technologies as part of their marketing strategies. For example, luxury car maker Maserati uses its website for customers to design their own specification. Each car is made to order, with customers selecting (online) the colour, the type of leather, the type of wood, the preferred audio and entertainment system, the choice of wheels and so forth, thereby creating a unique product that suits their individual preferences and price tag.

Different businesses approach marketing strategy in different ways. Those that are market orientated give customers top priority. This marketing strategy may well suit the marketing of services although it is not necessarily the best approach for the marketing of hi-tech goods that require extensive product research and development. Nevertheless, most businesses adopt a market orientation strategy, especially as customers are increasingly more knowledgeable and have greater access to alternative suppliers. These organizations are more perceptive of their customers' needs and wants, so stand a better chance to survive in an ever-changing business world.

Without proper marketing planning, marketing strategies are likely to fail. For example, managers might not have considered the intensity of competition in the marketplace or changes in market conditions. The role of marketing helps to give a sense of direction to the business and ensures that marketing activities are appropriately coordinated and managed. However, a dilemma faced by marketers is that the nature of business is dynamic and always exposed to the forces of continual, erratic and unpredictable change. This means that marketers need to build in some flexibility so their marketing strategies can be changed spontaneously. In their book *Uncommon Practice*, A. Milligan and S. Smith (2002) argued that the fastest way to build a name in business is to command attention to an organization's products. In essence, this is what marketing is all about.

Key concept

With reference to an organization of your choice, examine how **creativity** and **sustainability** have influenced its marketing practices.

Key concept

With reference to an organization you have studied, discuss how **change** and **ethics** have influenced the role of marketing.

REVIEW QUESTIONS

1. How do needs differ from wants?
2. What is marketing about?
3. What is meant by market orientation?
4. What is meant by product orientation?
5. What is market share and how is it calculated?
6. What is meant by market growth and how is it calculated?
7. What is market leadership?
8. What are the benefits of being a market leader?
9. What might be some of the challenges that market leaders face?
10. How do ethics influence marketing practices and strategies?

KEY TERMS

The **concentration ratio** is an indicator of the degree of competition in an industry by calculating the sum of the market share held by the largest specified number of firms in the industry.

Ethical code of practice refers to guidelines that help businesses to act in a moral way by considering what society accepts as ethically right or wrong.

Market concentration measures the degree of competitiveness that exists within a market by calculating the market share of the largest few firms in the industry.

Market growth refers to the rate at which the size of a market is increasing, typically expressed as the percentage increase in the market size of an industry per year.

Market leadership is the position of a business which has the largest market share in a given market for a particular good or services.

Market orientation is a marketing approach adopted by businesses that are outward looking by focusing on making products that they can sell, rather than selling products they can make.

Market share measures an organization's portion of the total value of sales revenue in a specific industry.

Market size refers to the magnitude of an industry, usually measured in terms of the value of sales revenue from all the businesses in a particular market, per time period.

Marketing is the management process of predicting, identifying and meeting the needs and wants of customers, usually in profitable ways.

Marketing objectives are the specific marketing goals of an organization, such as increased sales revenue, greater market share and market leadership.

Marketing strategies are the medium- to long-term plan to achieve an organization's marketing objectives.

Needs are the essential necessities that all humans must have to survive, such as food, shelter, warmth and water.

Product orientation is a marketing approach used by businesses that are inward looking as they focus on selling products that they can make, rather than making products that they can sell.

Wants are human desires, i.e., things that people would like to have. Irrespective of personal income or wealth, humans have infinite wants.

Chapter 24
Unit 4.2 - Marketing planning

"You generally hear that what a man doesn't know doesn't hurt him, but in business what a man doesn't know does hurt."
- E. St. Elmo Lewis (1872 - 1948), American author

Contents

4.2 Marketing planning	
SL/HL content	**Depth of teaching**
The role of marketing planning	AO2
Segmentation, targeting (target market) and positioning (position maps)	AO2, AO4
The difference between niche market and mass market	AO2
The importance of having a unique selling point/proposition (USP)	AO2
How organizations can differentiate themselves and their products from competitors	AO3

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CORE

The role of marketing planning (AO2)

A **marketing plan** is a document outlining an organization's marketing objectives and the marketing strategies to be used to achieve these objectives. Successful marketers advocate the planning of marketing objectives and strategies, rather than adopting an ad hoc and uncoordinated approach.

A marketing plan is usually preceded by a **marketing audit** - a review of the current position of an organization's marketing mix, in terms of its strengths and weaknesses and consideration of opportunities and threats facing the organization. The audit might address questions and issues such as the intensity of competition in the market, the firm's product portfolio (see Chapter 27) and an assessment of the effectiveness of its marketing.

From the marketing audit, managers can then produce a marketing plan. A marketing plan is likely to include details of the following elements or components:

- Marketing objectives that are SMART (specific, measurable, agreed, realistic and time bound), such as the expected market share or sales turnover within a specified time frame.
- An assessment of the strengths and weaknesses of competitors in the market.
- Methods of market research to be used to identify target markets.
- An outline of the marketing mix (see Chapters 27 - 33), including the product design, channels of distribution to be used, anticipated price(s) and pricing methods and the promotional strategies to be used.
- Details of the marketing budget, including planned revenues and expenditures.

- An outline of the anticipated difficulties and the strategies to deal with these foreseeable problems.

It is also common to include SWOT and STEEPLE analyses in a marketing plan (see Chapters 44 and 46 respectively). These business management tools help the organization to assess the internal and external factors affecting the business and adds context to its marketing objectives.

Marketing planning is a systematic process of devising marketing objectives and appropriate marketing strategies to achieve these goals. It requires the collection and analysis of information about a particular market, such as market research data on existing and potential customers. The typical marketing planning process involves the following five stages:



Figure 24.1 - The marketing planning process

- Marketing audit - This is an examination of the current climate in which the business operates. Market research is integral to this investigation.
- Marketing objectives - The marketing audit enables the business to set marketing goals and targets, such as improved competitiveness or increased market share.
- Marketing strategies - This refers to the plan and use of an appropriate marketing mix to achieve marketing objectives.
- Monitoring and review - This is a continual process of checking and monitoring of progress so that marketing objectives can be met. Hence, marketing strategies might need to be adjusted accordingly.
- Evaluation - This is an examination of the extent to which the business has succeeded in achieving its marketing objectives. The evaluation is used to aid decision-making and subsequent rounds of marketing planning.

The main advantage of marketing planning is that it improves an organization's chances of success. Of course, the marketing plan does not guarantee success, but it can help managers to identify and deal with anticipated problems. The various functional areas of a business will also have a clearer idea of the organization's objectives and the constraints in which they are to operate. Thus, a key role of marketing planning is to allow marketing managers to have better control of their operations.

However, marketing planning has its limitations. For example, many small businesses do not have the time, resources or expertise to plan their marketing in such a systematic way. They react to (rather than anticipate and plan for) changes in the marketplace. Even for large organizations, managers need to devote appropriate resources (time, people and finance) to marketing planning. Marketing plans can be inflexible and become outdated quite quickly as they do not allow for sudden changes in market conditions. This is especially the case in high-tech and fast-paced industries.

Segmentation, targeting and positioning (STP)

Segmentation, targeting (target market) and positioning (position maps).

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The segmentation, targeting, positioning (STP) marketing model is a commonly used strategic approach to modern marketing. A market for a particular good or service consists of different types of customers, subdivided into market segments (or distinct subgroups of a market). For instance, there are many markets that exist to meet the needs and wants of children, such as education, toys, food, clothing and entertainment. The STP marketing model consists of three steps:

1. Segmenting the market.
2. Targeting the most commercially valued groups of customers.
3. Positioning the firm's offering in the market.

A **market segment** refers to a distinct group of customers with similar characteristics (such as age or gender) and similar wants or needs. By dividing the market into different segments, it is easier for a business to analyse which groups of customers buy the product and then to target these customers more distinctively using a focused marketing mix for each market segment.

Once the market is segmented, businesses can then focus on targeting these specific subgroups of the market. **Targeting** refers to each distinctive market segment having its own specific marketing mix. For example, business and first-class air travellers are targeted in a very different way to those who travel by economy class. Teaching vacancies are advertised weekly in the *Times Educational Supplement* (www.tes.co.uk), a specialist newspaper publication targeted at teachers.

Case study 24.1 - Marriott International

Marriott International is an American multinational company that owns and operates a number of different hotel chains that target different consumer groups. Its premium brands include The Ritz-Carlton and W Hotels that target customers willing and able to pay premium prices for distinctive luxury. Its upscale hotel brands include Marriott Hotels & Resorts, Sheraton Hotels and Resorts and Le Méridien. A more affordable option targeted at travellers who simply want a nice and clean place to stay is Courtyard by Marriott hotels. Understandably, Marriott International does not use the same marketing strategies for all of its customers. Each hotel chain is planned and positioned to appeal to the unique wants and needs of the specific customer group.

Case study 24.2 - Kering

In reality, many businesses have operations that use various targeting strategies. For example, French multinational company Kering, which owns luxury brands Gucci and Yves Saint Laurent, developed its product portfolio by owning a minority stake in sports brand Puma in order to spread its risks. Kering also owns FNAC, the largest French consumer electronics retailer that operates throughout Europe.

Consumer profiles are the demographic and psychographic characteristics of consumers in different markets, such as their age, gender, occupation, income level, religion, marital status and purchasing habits. For example, the typical pensioner might be described as someone who is above 65 years of age on a fixed income (pension) and has no mortgage. The typical consumer profile for Lego toys is male children aged between 3 - 15 years, although other segments exist, such as females as well as adults (what Lego refers to as AFOL - Adult Fans of Lego).



Figure 24.2 - Lego targets its toys at different market segments

Knowledge of consumer profiles helps a business to identify the needs and wants of its customers and to identify any segments that might be overlooked. For example, Coca-Cola realised through market research that health-conscious male customers were reluctant to purchase Diet Coke or Coke Light as these products tended to be associated with female customers. This gap in the market led to the launch of Coke Zero, nicknamed 'Bloke Coke', in 2005.

Business Management Toolkit

According to The Economist, around 87% of its readers are male, 46% are in senior management positions and 69% of readers admit to being ambitious in their careers/professions. The average reader's net household wealth is $1.7m.

Source: The Economist (http://goo.gl/YQIxMp)

Discuss how such descriptive statistics (see Chapter 50) might be of value to businesses such as The Economist Group, the media company that owns The Economist.

CORE

Marketing

Recall that market segmentation is the process of splitting the market into distinct consumer groups to better meet their needs. Businesses segment their markets for several reasons:

- *Better understanding of customers* - Market segmentation enables a business to better understand the needs and wants of its various customer groups. A clearer marketing strategy therefore reduces the chances of wasting resources on marketing products in the wrong places and to the wrong people.

- *Higher sales revenues* - Being able to cater for a wider range of customers in a market can help a business to sell more products and hence earn more profit.

- *Growth opportunities* - Effective market segmentation can help businesses to identify new opportunities in local, regional and international markets.

- *Support for product differentiation strategies* - Having a better understanding of different market segments allows a business to effectively differentiate its products and spread its risks by devising more appropriate marketing plans and marketing mixes for different subgroups of the market.

Organizations segment their markets in order to create distinct consumer profiles in several ways, typically based on: (i) demographic, (ii) geographic and/or (iii) psychographic factors.

(i) Segmentation by demographics

Demography is the study of the characteristics of the human population within a certain area, region or country. It looks at a range of variables such as the following:

- *Age* - Within each age grouping (such as pre-teens, teenagers and the retired population) people tend to have similar needs and wants. They may also be in similar financial circumstances, such as the typical university undergraduate being in debt. Young children, teenagers, parents with babies and those who are retired have different spending patterns.

- *Gender* - Males and females can have very different wants and spending habits. For instance, there is a huge market for women's fashion in comparison to men's fashion (just take a look at the proportion of floor space devoted to female clothing compared to that allocated to male customers in a typical shopping mall or retail park).

Case study 24.3 - Lego

Lego's profits jumped 35% in less than a year following its introduction of LEGO Friends™ in 2012, targeted specifically at girls. The Danish toymaker, founded in 1932, had previously targeted their toy products mainly at boys only. By 2013, LEGO had overtaken Mattel to become the world's most valuable toy company.

- *Race and ethnicity* - Different races of people have different cultures (see Chapter 54), which can affect their demand for different products. For example, lots of people in Southeast Asia eat rice as part of their staple diet, whereas those in Belarus, Ukraine, Latvia, Rwanda and Russia tend to prefer potatoes. Due to globalization, there are many opportunities for international marketers to sell cultural exports to reach a wider customer base (see Chapter 34).

- *Marital status* - In many parts of the world, an increasing number of people are delaying marriage, partly due to the soaring costs of weddings and due to the career aspirations of women. Divorce rates in many modern societies have also been on the increase. Such trends can present both opportunities and threats to marketers.

- *Religion* - Religious faiths create markets for goods and services in every country. For example, Jewish people buy kosher foods whereas Muslims do not eat pork. McDonald's has had to alter its menus in countries such as India where beef is not consumed for religious reasons.

- *Languages* - Businesses may cater for different customers based on different mother-tongue languages. For example, IB programmes and examinations exist in three main languages: English, Spanish and French. Most famous tourist destinations, such as Stonehenge in the UK and Tokyo Disneyland, cater for international visitors.



Figure 24.3 - Stonehenge is a popular attraction for tourists in the UK

- *Income and socio-economic class* - Very wealthy people tend to have different spending patterns from the rest of the population. For example, the American 'upper-middle class' refers to highly educated salaried professionals who earn in excess of $65,000 per year or have an annual household income of at least $100,000. The UK uses a similar model (see Box 24.1). The level of income for different consumer groups can affect the pricing methods used by a business. For example, cinemas and theme parks charge different prices to adults, children, students, families and pensioners.

Case study 24.4 - The Emirates Palace

The Emirates Palace in Abu Dhabi is a 7-star 'super luxury' hotel, which cost $6 billion to build – the world's most expensive hotel ever to be built at the time (2005). It has its own private beach, private cricket ground and a rugby pitch. Suites cost from $10,000 per night, whilst its Valentine's Day package is $1 million per night. Guests staying at the hotel also have the privilege of being able to use the world's first gold vending machine.



The Emirates Palace, Abu Dhabi

Box 24.1 - Demographic groups (UK model)

Social group	Social status	Description and examples of occupation
A	Upper-middle class	Senior managerial, administrative or professional workers, e.g., company directors, diplomats, barristers and surgeons.
B	Middle class	Middle managerial, administrative or professional workers who tend to be highly educated and salaried staff, e.g., teachers, nurses and accountants.
C1	Lower middle	Skilled non-manual workers, e.g., supervisory (junior managerial), administrative or clerical professionals.
C2	Skilled working class	Skilled manual workers, e.g., self-employed plumbers, plasterers, mechanics and electricians.
D	Working class	Semi-skilled and low-skilled manual workers, e.g., assembly line factory workers and cleaners.
E	Subsistence	Unskilled and casual workers, state pensioners and the unemployed.

Source: adapted from http://www.abc1demographic.co.uk/

Box 24.2 - Creative demographic segmentation

Marketers have invented many creative acronyms and names for various demographic segmentation groupings. Examples include:

- *DINKY* – double income, no kids yet
- *DINKER* – double income, no kids, early retirement
- *NILK* – no income, lots of kids
- *OINK* – one income, no kids
- *GLAM* – greying, leisured, affluent, middle-aged
- *ORCHID* – one recent child, hugely in debt
- *OPAL* – older people with active lifestyles
- *WOOF* – well off older folk
- *RAP* – retired affluent people
- *Kidults* – adults who purchase products aimed at children, e.g. certain toys or computer games
- *Tweenagers* – children aged 7– 12
- *SITCOM* – Single income, two children, outrageous mortgage
- *SINBAD* – Single income, no boyfriend and desperate!

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Marketing

In reality, different combinations of these demographic factors are used for marketing purposes. For example, greetings cards are produced for numerous occasions such as birthday cards specifically for girls, boys, teenagers, parents and grandparents and different cards for Thanksgiving, Christmas, Hanukkah, Diwali and Lunar New Year.

(ii) Segmentation by geographic factors

The geographic location of customers can have implications for segmentation because demographic factors can be largely influenced by geographic variables. Race, language and religion are some examples. Geographical factors affecting market segmentation fall into two broad categories:

- *Location* - Different geographical areas and regions may have different cultures and social attitudes. Singapore and Malaysia, for example, are very multicultural and most businesses cater for the three main cultures - Chinese, Malay (or Singaporean) and Indian.

- *Climate* - The typical weather in a geographical area can have a large impact on business activity. Warm clothing product lines such as scarves, boots and hats are unlikely to meet the needs of people living in areas with a tropical climate, but more suited to those in cold countries or tourist hikers climbing mountains. Hence, many businesses are likely to adjust the products they sell in different parts of the world.



Figure 24.4 - British Columbia, Canada, has plenty of trails for mountain hikers

(iii) Segmentation by psychographic factors

Psychographic factors are those that consider the emotions and lifestyle of customers, such as their hobbies, interests and values.

- *Values* - This refers to people's beliefs, morals and principles. Ethically responsible businesses such as The Body Shop appeal to people who are against the use of animal testing. Advocacy groups (or pressure groups) such as Greenpeace and Amnesty International aim to win the backing of people to support their cause.

- *Religion* - As outlined above, this can provide many business opportunities. For example, it is estimated that

there are over 2.6 billion Christians in the world; a figure that is not overlooked by international marketers.

- *Status* - Some people are very conscious of social and economic status. A feeling of status can come about due to the feel-good factor of owning certain assets, such as designer outfits, luxury jewellery or sports cars.

- *Culture* - The culture and buying habits of different ethnic groups and people in different regions of the world can provide immense opportunities for marketers, such as the increased trade in cultural exports.

- *Hobbies and interests* - An understanding of the different hobbies and interests of customers can provide plenty of marketing opportunities for a business. For example, the sports industry is huge, catering for customers that actively participate in and/or watch a wide variety of sports.



Figure 24.5 - Sporting interests provide many marketing opportunities

Question 24.1 - Oasis Hong Kong Airlines

Oasis Hong Kong Airlines (Oasis) was the first airline to adopt the budget airline model for long haul flights since the collapse of Laker Airways back in 1982. Oasis's maiden flight from Hong Kong to London in October 2006 attracted negative media coverage as the flight was delayed by 24 hours due to airspace clearance problems from Russia. The return flight was also delayed by over two hours due to a damaged emergency exit door.



Faced with intense competition from stronger and more established rivals, such as Cathay Pacific and Singapore Airlines and with only two aircraft in its fleet, not all customers were keen to take advantage of the low prices of Oasis. Nevertheless, by June 2007 the airline had launched its second flight route from Hong Kong to Vancouver.

(a) Outline why Oasis's business approach might have been considered as being innovative at the time. *[2 marks]*

(b) Comment on why customers were not overly keen to fly with Oasis, despite the airline's low prices. *[2 marks]*

(c) Examine the key differences in the marketing strategies that Oasis could use to attract different market segments. *[6 marks]*

Question 24.2 - The business of international students

International students provide many opportunities for businesses. In addition to their direct costs of education, these students help to improve domestic tourism, especially with visiting friends and relatives. World Bank figures show that international students account for a significant proportion of service export earnings in many countries (such as Australia, New Zealand, the UK and the USA), including student accommodation, retail, entertainment, healthcare and travel services.

The international mobility of students is being fuelled by three main factors: the phenomenon of globalization, **innovations** that make education more accessible to people from around the world and the intensity of **competition** between universities to attract overseas students.



The University of Oxford, England

(a) Outline what is meant by *innovations*. *[2 marks]*

(b) Describe what is meant by *competition*. *[2 marks]*

(c) Examine how knowledge of market segmentation might help universities to have more cost-effective marketing activities to attract overseas students. *[6 marks]*

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Case study 24.5 - BMW

Segmentation is about anticipating the needs of different customers. As part of its business strategy, BMW has used segmentation and consumer profiling to increase its sales revenue and profits.

BMW's range of cars come in all sorts of sizes (such as the entry level 1-Series, its M-Sports range and its X-Series SUV) and styling to suit different customers. BMW cars appeal to both men and women, of different nationalities, earning varying levels of salaries. In 2011, BMW launched its i-model plug-in electric vehicles. In less than 5 years, the company had sold over 50,000 units of the BMW i3 and i8 models. Today, the i3 is one of the world's best-selling all-electric cars. Despite the prolonged COVID-19 pandemic, BMW sold over 2.2 million vehicles across the world in 2021, which was a rise of over 9% over the previous year.

Once a market has been segmented, targeting becomes the next stage in marketing planning. **Targeting** refers to the market segment(s) that a business wishes to sell to. Appropriate marketing strategies are then developed for these target markets. There are two broad targeting strategies that a business can use - niche marketing or mass marketing (see section below).

Once a business has determined the target customers for its goods and services, a positioning strategy is then needed. This requires the business to determine how best to differentiate each market segment and then to devise an appropriate marketing mix for each targeted segment.

A **product position map** (or **perception map**) is a visual tool that reveals customer perceptions of a product or brand in relation to others in the market. The term was coined by marketing guru Jack Trout in 1969. The two-dimension diagram plots customer perceptions using variables (or criteria) such as price and quality, as shown in Figure 24.6. An example of a perception map for the motorcar industry is shown in Figure 24.7

		Quality	
		High	*Low*
Price	*High*	Premium products	Cowboy products
	Low	Bargain products	Economy products

Figure 24.6 - Perception map (customer perceptions based on price and quality)

- **Premium products** are of goods and services of high quality and high prices, such as Mercedes-Benz cars and Cartier watches.
- **Economy products** are those of low quality but at appropriately low prices, such as supermarkets that supply 'no-frills' (own-label) branded grocery goods to attract price-sensitive customers.
- **Bargain products** are goods and services of high quality but with low prices. This strategy is not sustainable and this positioning approach is only used as a short-term tactic to boost sales.
- **Cowboy products** are of poor quality yet highly priced. These products are positioned to deceive customers and are therefore only used as a short-term tactic to gain sales revenue but can give the business a negative corporate image.

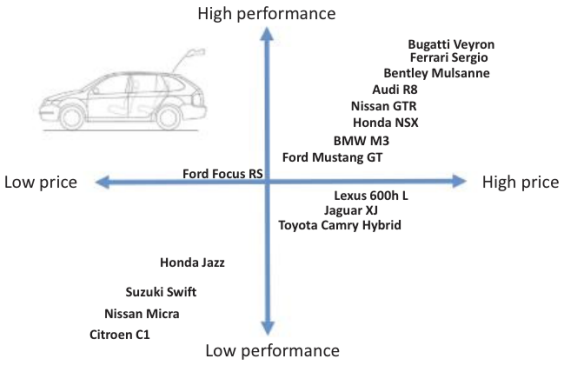

Figure 24.7 - Perception map for the motorcar industry

Position maps allow a business to identify any gaps in its product portfolio (see Chapter 27). For example, Mercedes-Benz introduced its A Class cars in 1997 after market research revealed there was a market for smaller cars that featured its luxury brand name. Similarly, BMW identified a gap in the market for luxury 4×4 sports utility vehicles (SUV), so subsequently introduced its X Class line of cars in 2008. By the end of 2020, BMW had sold 491,509 units of the X6 across the world – sales that it would not have had if the company did not target customers in the SUV market.



Figure 24.8 - The BMW X6

Information in a perception map can also help businesses to refine their marketing strategies. For example, if customers perceive a particular brand to be of high price and high quality, then appropriate market segments can be targeted. For instance, in the cosmetics industry, Chanel is regarded by customers to be of higher quality and price compared to Rimmel. Similarly, most customers perceive Evian and Perrier as superior brands of bottled water.



Figure 24.9 - Evian is perceived as a premium brand

A major advantage of perception mapping is its simplicity in presenting potentially complex market research findings. The maps are quick and easy to interpret. They can inform marketing managers about market opportunities and threats. For example, if undesired perceptions exist, the business will need to use appropriate marketing strategies to **reposition** its products. Repositioning is a marketing strategy that involves changing the market's perception of a firm's product or brand in comparison to rival businesses. For example, British Airways

revamped its image to appeal to younger and less affluent customers after market research findings revealed the airline was associated with wealthy and elderly travellers only.

There are three stages to positioning:

- *Identifying* the competitive advantages of the product in question.
- *Deciding* on which aspects of these strengths should be marketed.
- *Implementing* the desired positioning by using an appropriate marketing mix.

Professor Michael Porter proposed three generic (or basic) competitive strategies for businesses to achieve market positioning success:

- **Cost leadership** - This strategy involves the business aiming to excel as low-cost suppliers of particular economy products.
- **Differentiation** - This strategy involves producing distinct products to distinguish them from those supplied by competitors. Having a distinctive or unique selling point can give the organization competitive advantages.
- **Focus** - This approach involves a business paying close attention to a particular market segment, such as high-end premium products or specific niche markets.

Porter argued that it is unrealistic for a business to be good at everything in all market segments and such an approach would result in the business not being good at anything in particular (see Chapter 53). For example, he suggested that a business cannot logically and simultaneously provide cost leadership and high quality.

Perception affects the corporate image of a business. Corporate image plays a vital part in the success of an organization. In 2007, Pakistan International Airlines was banned from flying to the European Union due to safety concerns. In the same year, America raised concerns over Indonesian airline carriers due to their poor safety record. A poor image not only drives customers away but can also cause irrevocable damage (see Case study 24.6).

Case study 24.6 - Ratners

One of the most famous corporate bloopers in business history was made by Gerald Ratner in 1991. His company, Ratners, was once the UK's largest mass market jeweller with 80% market share. However, in a speech to over 6,000 members of the Institute of Directors back in 1991, Gerald Ratner joked that his company's earrings were 'total crap' (slang for extremely poor quality) and added that a prawn sandwich from Marks & Spencer would cost more and last longer! Subsequent media coverage effectively ended the company after its market value dropped by around £500 million ($725m). Perception is everything when it comes to marketing!

Business Management Toolkit

With reference to an organization of your choice, examine how Porter's generic strategies (see Chapter 53) can help a business to achieve market positioning success.

Theory of Knowledge (TOK)

To what extent can we rely on sense perception to make knowledge claims in Business Management?

Common mistake

When using perception maps in the exams, students often create or refer to a position map based on their own personal perceptions of certain brands and products. This is inappropriate as the tool is used to gauge the perceptions of the target markets (customers as a whole, rather than opinions of a single person).

In summary, the STP marketing model is useful for creating marketing plans as it helps marketing managers to prioritize marketing propositions. It also helps marketers to develop and implement personalized and relevant marketing communications to engage with different market segments.

Question 24.3 - The hotel industry, London (UK)

The data below show customer perceptions of several hotels in London.

Hotel	Price	Quality of service	Desirability of location
Britannia International	High	High	Medium
Holiday Inn	Medium	Medium	Low
Peckham Hotel	Medium	Low	Low
Premier Travel Inn	Medium	Medium	Medium
Raddison	High	Medium	High
Savoy Hotel	High	High	High
Shaftsbury Hyde Park	Medium	Medium	High
Travelodge	Low	Low	Low

(a) Construct a position map for the hotel industry in London based on the information above. *[4 marks]*

(b) Explain the benefits of position maps to the operators of both Savoy Hotel and Peckham Hotel. *[6 marks]*

Niche and mass markets

The difference between niche market and mass market. AO2

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Niche marketing targets a specific and well-defined market segment. For example, some businesses provide high-end speciality goods in niche markets (such as Louis Vuitton handbags, Bugatti supercars and Cartier watches), catering for consumers interested in exclusive luxury goods. Businesses that cater for minority sports also operate in niche markets, such as horse riding, Ultimate Frisbee, Wakeboarding and Tae Kwon Do. The advantages and disadvantages of niche marketing are outline in Table 24.1.



Figure 24.10 - Horse riding is a niche market sport

Photgraph courtesy of Victor Chine

Table 24.1 - Advantages and disadvantages of niche marketing

Advantages of niche marketing	Disadvantages of niche marketing
There is better focus as a specific market segment is targeted. By contrast, mass marketing has no real focus and markets products to all customers.	Niche markets are small which limits the number of potential customers in the market. By contrast, mass markets cater for a much wider customer base.
As there is less competition, businesses can charge higher prices for their unique or exclusive products. This helps the business to benefit from higher profit margins on its products.	Due to the limited market size, businesses operating in niche markets have few, if any, opportunities to exploit economies of scale. Thus, average costs of product tend to be higher.
Businesses become highly specialized in meeting the needs and wants of their niche target market. This can help to deliver first-rate customer service and encourages customer loyalty.	Successful and profitable niche markets attract new entrants into the industry. The threat of larger firms entering the market might endanger the survival of businesses operating in niche markets.

Case study 24.7 - Lefty's – The Left Hand Store

Lefty's – The Left Hand Store is a business founded in San Francisco, USA. Eastablished in 1978, it was the very first business in the USA to specialize in products for left-handed people. Lefty's also has a kiosk at Walt Disney World Resorts in Orlando, Florida.

Source: http://www.leftyslefthanded.com

Case study 24.8 - The IB's niche market subjects

Did you know that the IBO offers a range of subjects that can be considered as niche market subjects? These subjects follow what is called the 'School Based Syllabus' (SBS), available at Standard Level only, so must cover a minimum required 150 teaching hours. SBS subjects include Asian Arts, Astronomy, Brazilian Social Studies, Drama, Electronics, Fijian Studies, Food Science & Technology, Human Rights, Marine Science, Nature of Science, Turkey in the 20th Century, World Arts & Cultures and World Religions.

Question 24.4 - Pink Ladies



Pink Ladies is a member's club for women only, including a unique private car hire service - driven by women for women. The business was established in 2005 by Tina Dutton and Andrea Winders, who had concerns for lone women travellers and worries about the dangers of the many unlicensed taxi drivers in London, UK. The firm's taxis, which of course are all pink, come with satellite navigation devices and female drivers trained in self-defence. To bolster security even further, the firm was a pioneer of a 'no cash in the car' policy. Market research showed that women generally feel happier with a female driver.

(a) Describe what is meant by *market research*. *[2 marks]*

(b) Explain **two** methods of market research techniques that Pink Ladies were likely to have used. *[4 marks]*

(c) Explain **two** advantages for Pink Ladies operating in a niche market. *[4 marks]*

Photo courtesy of Andrea Winders and Tina Dutton (pictured), www.pinkladiesmembers.co.uk

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Marketing

Mass marketing refers to undifferentiated marketing. It is an approach to marketing that ignores targeting individual market segments. Instead, a broad range of market segments are targeted collectively to maximize sales. Coca-Cola, Samsung, Nike, Toyota and Lenovo all use this strategy to target various market segments for their products. Table 24.2 outlines the advantages and disadvantages of mass marketing.

Table 4.2.b Advantages and disadvantages of mass marketing

Advantages	Disadvantages
Businesses can gain from huge potential economies of scale by supplying products in mass markets, thereby helping them to cut unit costs and/or raise profit margins.	Mass marketing is not suitable for all businesses due to the high barriers to entry required for mass production, such as high set-up costs.
There is no need to modify marketing strategies for different market segments as the whole market can be targeted with a single marketing campaign. This saves both time and resources.	Competition can become quite fierce as customers must be persuaded to buy the firm's products rather than to buy from a competitor. Thus, marketing budgets must be substantial to remain competitive.
Catering for larger (mass) markets means that the business can establish a larger customer base, thereby earning higher sales revenues and more profits.	As there is a lack of focus, mass marketing can be quite wasteful, as specific consumer groups are not being directly targeted.

Unique selling point (USP)

The importance of having a unique selling point/proposition (USP). AO2

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There are many possibilities for a business to improve its corporate image, such as the pursuit of ethical objectives and implementing corporate social responsibility (see Chapter 3). Alternatively, businesses might seek to develop and market their unique selling point (USP). A **unique selling point** or **unique selling proposition**, is any aspect of a business, product or brand that makes it stand out from those offered by competitors. Consider a USP in the same way as a student applying for a university course or an applicant for a job - both need something unique or distinctive, to differentiate them from rivals in the market. Businesses exploit their USP by included this in their marketing strategies.



Figure 24.11 - Having a USP can help firms to sell their products

The USP explains *why* customers buy the product over rival ones, such as its distinctive features or appealing packaging. Products with a USP are often promoted by word of mouth and social media (see Chapter 29), which also saves the business on its marketing budget. A USP can be a major source of competitive advantage and therefore businesses want to emphasise their USP to attract customers, such as Pink Ladies which offers a female only taxi service in the UK (see Question 24.4). Other, more generic examples of a USP include:

- Being the only firm in a local area to supply a certain good or service.
- Having a reputation for being the 'best' in the market, e.g., Apple, Samsung and Toyota are market leaders (see Chapter 23).
- Having a reputation for being a low-cost provider in a market, e.g., Walmart's claim of "Save Money. Live Better" or Ryanair's "Fly cheaper. The Low Fares Airline."
- Having a highly popular business slogan, such as 'Just Do It' from Nike, 'Happy Meal' from McDonald's or 'Because You're Worth It', which has been used by L'Oréal since 1971.
- Being the first business to provide a certain product (known as a **first mover advantage**).

Although having a USP can be advantageous, it can be extremely difficult to establish and maintain. In reality, once a business creates a successful USP in a market, others enter the market to compete.

Case study 24.9 - IBID Press

IBID Press (www.ibid.com.au/business-management/) was the first publisher to launch a dedicated textbook for the IB Business Management course, back in 2007 - our USP remains being the most comprehensive textbook available for the IB DP Business Management course.

Case study 24.10 - The Coca-Cola Company and Christmas



Coca-Cola is one of the most recognised brands on the planet. The Coca-Cola Company claims to have created the red and white outfit worn by Santa Claus - the same colours as its iconic brand logo and packaging. To date, no one has been able to successfully debunk the Coca-Cola Company's claim.

Common mistake

Do not confuse unique selling propositions with business slogans (catchphrases) or mission statements, even though they may be linked. What a business intends to achieve (through slogans or mission statements) does not necessarily give it a unique selling point.

Question 24.5 - J.D. Power and Associates



J.D. Power and Associates is the motor industry's benchmark for judging the quality of new cars, based on its annual Vehicle Dependability Study from owners of new motor vehicles. Lexus and Porsche lead the luxury brands, while Toyota, Kia and Hyundai dominate among the **mass market** brands for most reliable cars on the planet. Understandably, these manufacturers have used the J.D. Power and Associates ratings in their marketing campaigns.

(a) Define the term *mass market*. *[2 marks]*

(b) Explain how quality awards and ratings, such as those awarded by J.D. Power and Associates, can provide certain car manufacturers with a unique selling point (USP). *[4 marks]*

(c) To what extent does having a unique selling point in a highly competitive market, such as the motor industry, help an organization to achieve its objectives? *[10 marks]*

Case study 24.11 - De Beers

De Beers Group is a group of companies that dominates the market for diamonds. In 2000, Advertising Age magazine named "A diamond is forever" (the corporate slogan of De Beers since 1948) as the best advertising slogan of the 20th Century, having used it successfully to market diamonds as a symbol of enduring love and commitment.



Figure 24.12 - Product differentiation is about making a good or service that stands out from rival ones in the market.

CORE

Differentiation

How organizations can differentiate themselves and their products from competitors. AO3

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Differentiation is the act of distinguishing a business or its products from competitors in the market. Product differentiation tries to create the perception among customers that the organization's goods and services are different (unique, exclusive or special), so adds value compared to the substitute products from rival businesses. Hence, a differentiation strategy involves making a product stand out from others available in the market. By having a unique or distinctive element to the product, differentiation can help a business to thrive and compete effectively. Common methods of differentiation evolve around the various elements of the marketing mix (see Chapters 27 - 33):

- *Product* - Distinctive features of a product could include its design, functions, build quality and/or performance. For example, businesses can differentiate the quality of their products by using better quality raw materials and components or by achieving international quality accreditation (see Chapter 37). This gives the business a competitive advantage and enables the organization to charge premium prices for its products (see Chapter 28).
- *Price* - Different pricing strategies (see Chapter 28) enable a business to sell a range of products, from economy brands to luxury versions. Businesses can also offer discounts for multiple (bulk) purchases. In the services sector, many

businesses charge different fees for different levels of service, such as business and first-class air travel.

- *Promotion* - Businesses can differentiate themselves or their products from others through various promotional methods (see Chapter 29) such as logos, slogans and branding. Nike's swoosh or the triple stripes of Adidas, for example, allow customers to instantly identify their products. Successful differentiation requires marketing support to promote a business and its products.

- *Place* - Differentiated marketing enables retailers, distributors and wholesalers to reach a wider range of customers (see Chapter 30). The internet, for example, continues to grow in popularity as a sales channel for many businesses around the world. Having an online presence can be a form of differentiation.

- *People* - Businesses can differentiate themselves by the quality of their customer service, especially when customers need a high degree of support, advice and after-sales care (see Chapter 31). The quality of people in an organization can help to develop a reputation that rivals find hard to match. Unique or special skills and expertise of employees can make the business a more attractive choice.

- *Processes* - The ways things are done and how efficiently these things are done can also be a differentiator for service providers (see Chapter 32). Providing convenience, such as free home delivery or options of online payment facilities, can positively distinguish a business from its competitors. In the digital age where people continually seem to be in a hurry, convenience is a vital source of competitiveness.

- *Physical environment* - For many businesses, the observable aesthetics and tangible appearance of the business can be an important differentiator. Hotels, schools, theme parks, gyms and jewellers are all examples. The physical location can also make it easier (convenient) for customers, giving the business competitive benefits.

- *Packaging* - Businesses use packaging in a variety of ways to differentiate their products, such as the use of colours and different packaging materials. Coca-Cola's iconic glass bottle, Red Bull's distinctive can design, Toblerone's triangular shape packaging, Tabasco's tiny bottle of its infamous sauce, Pringle's cylinder container and McDonald's Happy Meal boxes are examples of products that can be distinguished by their unique packaging and design. Some businesses, such as jewellers, use packaging as value added service whilst others use it as a form of promotion (see Chapter 29).

In reality, the possibilities for differentiation are almost endless; creativity and imagination (and perhaps budgetary constraints) are the only obstacles. As Albert Einstein famously said, "*Imagination is more important than knowledge. For knowledge is limited.*"

Table 24.3 - The advantages and disadvantages of differentiation

Advantages of differentiation	Disadvantages of differentiation
Price advantages - Firms can only charge relatively low prices for mass produced and standardized products as customers have other substitute suppliers to choose from. By contrast, differentiation can add value to a firm's goods and services, thus allowing it to charge higher prices.	*Differentiation can be very expensive* - For example, special sales promotions can be highly expensive. Only large companies have the financial resources to differentiate their goods and services in order to target a larger number of customers in different market segments.
Brand recognition and brand loyalty - These can be a source of competitive advantage. High brand awareness creates more opportunities for products to be sold, perhaps due to customer loyalty or simply because customers feel more comfortable buying a familiar and trusted brand.	*Economies of scale* - Cost savings cannot be fully exploited compared to mass production of a single, standardized product. Differentiation requires additional marketing costs, especially if the business caters for different customers in different markets.
Distribution advantages - Retail space is limited, so vendors such as supermarkets and convenience stores only stock the best-selling brands. Therefore, successful product differentiation improves placement (distribution) of a firm's products.	*Choice is not always desirable* - Excessive differentiation can drain a firm's resources and confuse customers, such as the pricing options used by mobile phone service providers or different levels of coverage provided by insurance companies.



Figure 24.13 - Luxury handbags can be differentiated by brand, colour, size, material and design

CORE

Theory of Knowledge (TOK)

Albert Einstein (1879 - 1955) claimed that *"Imagination is more important than knowledge. Knowledge is limited."* To what extent does this apply to the study of Business Management?

Theory of Knowledge (TOK)

How can managers know whether it is best for the organization to opt for an undifferentiated or differentiated approach to marketing?

Marketing

ATL Activity 24.1 (Research and communication skills)

Investigate examples of product differentiation in one of the following industries: airline carriers, fast food, hotels, higher education or any other industry of your choice. Share your findings with the rest of the class.

Marketing planning and the key concepts

Change is an important concept for marketing planning. Having a unique selling point, for example, can give a business a competitive advantage in the short term, but it is unlikely to be sustainable as competitors will respond accordingly. Competition can mean that businesses continually strive to differentiate themselves and their products from their rivals.

Changes occur for many reasons beyond the control of an organization, such as changes in technology, fashion and economic conditions. Hence, all aspects of marketing planning (such as marketing plans, the STP model and the marketing mix) are exposed to the forces of change. Marketing planning ensures that managers monitor and respond to these changes accordingly through the use of tools such as repositioning strategies. It also helps to reduce risks as marketing planning can help managers to make more informed decisions.

Ethical marketing is a growing part of strategic marketing planning. It refers to the social and moral responsibilities of marketers. Ethical marketing can present a moral dilemma for businesses - if firms sell products aimed at children that are perfectly legal, such as war toys or fast-food products, why shouldn't they be allowed to promote these toys? Marketers would argue that advertising can be informative, not just persuasive or pressurising. Marketing can also help customers to make better and more informed decisions by weighing up the costs and benefits of their purchases. Arguably, using inappropriate and unethical marketing strategies can damage an organization's brand image, so ethics shouldn't be an issue (in theory).

Strategic marketing planning involves segmentation, targeting and positioning. However, it is unlikely that smaller businesses will have the financial and human resources to target all segments. Hence, they may need to resort to more creative and cost-effective methods of marketing.

Essentially, effective marketing planning is an essential part of an organization's strategy and can help to ensure the firm's sustainability and longevity. A summary of marketing planning is shown in Figure 24.13, with the topics covered in Unit 4 of the syllabus.



Figure 24.14 - Aspects of strategic marketing planning

Business Management Toolkit

In developing effective strategies, marketing managers can choose from an array of additional tools, such as:

- SWOT analysis - Identification of a firm's marketing strengths, weaknesses, opportunities and threats (see Chapter 44).
- Ansoff's matrix - Marketing strategies for growth (see Chapter 45).
- STEEPLE analysis - Used to identify opportunities and threats in the external business environment that will impact marketing activities (see Chapter 46).
- Boston Consulting Group matrix - Development of a firm's product portfolio strategy (see Chapter 47).
- Force field analysis - Quantitative method used to implement and manage organizational change based on driving and restraining forces (see Chapter 55).

Marketing planning is essentially a prerequisite to marketing strategy (the ways in which the business intends to achieve its marketing objectives). Strategic decisions will affect the direction of the organization and determine its future prosperity and whether the business can survive in a sustainable way.

Key concept

With reference to an organization of your choice, discuss how **change** and **sustainability** have influenced its marketing planning.

Key concept

With reference to an organization of your choice, examine how **creativity** and **ethics** have influenced its marketing mix.

REVIEW QUESTIONS

1. What is a marketing plan?
2. What is a marketing audit?
3. What does the typical marketing planning process involve?
4. What are the benefits and limitations of marketing planning?
5. What is the segmentation, targeting, positioning (STP) marketing model?
6. How do market segments differ from target markets?
7. What is meant by consumer profiles?
8. What are the differences between segmentation by demographics, geographic and psychographic factors?
9. What is a product position (perception) map?
10. What is meant by repositioning?
11. What are Porter's generic strategies?
12. How do niche markets differ from mass markets?
13. Why might it be important for some businesses to have a unique selling point (USP)?
14. What is a first mover advantage?
15. How can organizations differentiate themselves and their products from competitors?



Figure 24.14 - Aspects of strategic marketing planning

Business Management Toolkit

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14. What is a first mover advantage?
15. How can organizations differentiate themselves and their products from competitors?

KEY TERMS

Consumer profiles are the demographic and psychographic characteristics of consumers in different markets, such as their age, gender, occupation or income level.

Differentiation is the art of distinguishing a business or its products from rivals in the industry. It tries to create the perception among customers that the organization's product is different (unique or special) compared to substitute products in the market.

Market segmentation is the process of categorizing customers into distinct groups with similar characteristics (such as age or gender) and similar wants or needs.

A **marketing audit** is a review of the current position of an organization's marketing mix, in terms of its strengths and weaknesses and consideration of opportunities and threats.

Marketing objectives are the targets that the marketing department wishes to achieve, such as sales growth or increased market share.

A **marketing plan** is a document outlining an organization's marketing objectives and the marketing strategies to be used to achieve these objectives.

Marketing planning is a systematic process of devising marketing objectives and appropriate marketing strategies to achieve these goals.

A **market segment** refers to a distinct group of customers with similar characteristics (such as age or gender) and similar wants or needs.

Marketing strategies are the various long-term actions taken by a business to achieve its marketing goals.

Mass marketing refers to undifferentiated marketing. This marketing strategy ignores targeting individual market segments.

Niche marketing targets a specific and well-defined market segment, such as high-end speciality goods.

A **product position map** (or **perception map**) is a visual tool that reveals customer perceptions of a product or brand in relation to others in the market, often by comparing perceptions about price and quality.

Repositioning is a marketing strategy that involves changing the market's perception of a firm's product or brand in comparison to rival businesses.

Segmentation is the process of categorising customers into distinct groups of people with similar characteristics and buying habits for market research and targeting purposes. Segmentation can be done by using demographic, geographic and psychographic factors.

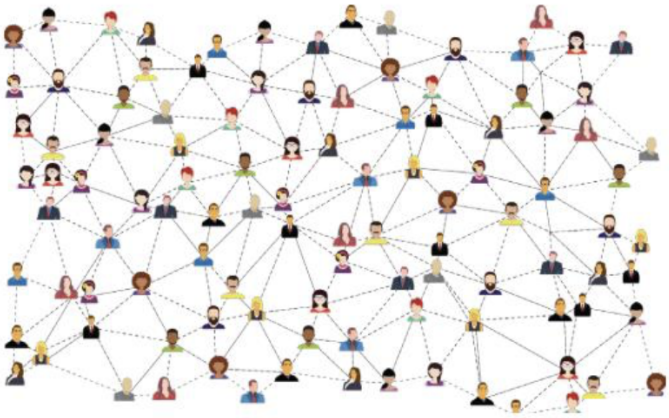

Figure 24.15 - Segmenting the market is an important aspect of marketing planning

A **target market** refers to a clearly identifiable group of customers that marketers choose to focus their efforts on, such as children, adults, men or women for a particular product.

Targeting refers to each distinctive market segment having its own specific marketing mix, depending on whether the business operates in niche or mass markets.

Unique selling point (or **unique selling proposition**) refers to any aspect of a good or service that makes it stand out (in a positive way) from those offered by competitors.

Chapter 25
Unit 4.3 - Sales forecasting (HL only)

HIGHER LEVEL

"Doubt is the key to knowledge"
- Persian proverb

Contents

4.3 Sales forecasting (HL only)	
HL content	**Depth of teaching**
The benefits and limitations of sales forecasting	AO3

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Sales forecasting

Sales forecasting is a quantitative management technique used to predict a firm's level of sales over a given time period. It is important because sales forecasts can help a business to identify problems and opportunities in advance. However, trying to predict what will happen in the future is difficult because there are so many variables that are subject to change. Hence, the forecasts may turn out to be inaccurate.



Figure 25.1 - Holiday destinations such as Nha Trang, Vietnam are subject to seasonal fluctuations

To make realistic and accurate sales forecasts, managers use a different number of sales forecasting techniques. These include:

- **Market research** - Identifying and forecasting the buying habits of consumers can be vital to a firm's prosperity and survival. For example, despite being the top global producer of cars for 76 years, General Motors (GM) grew complacent and overproduced cars as it had failed to recognise the changing demands of customers. With soaring oil prices and greater concerns for the environment, Toyota surpassed GM as the top motor manufacturer, with its highly successful fuel-efficient, hybrid and electric vehicles.

- **Extrapolation** - This forecasting technique identifies a firm's sales trend by using historical data and extending this trend to predict future sales. For example, if a firm's sale revenues have increased by an average of 3% each year for the past several years, then it might be expected that this trend continues in the near future. Graphically, the trend can be shown by a line of best fit (see Chapter 58) and extrapolation simply extends this line to make predictions. Extrapolation works well if there is a clear correlation (relationship) between two data sets, such as sales revenue over a period of time or the correlation between marketing expenditure and sales growth. Extrapolation is covered in Chapter 58.

HIGHER LEVEL

- **Time series analysis** - This sales forecast technique attempts to predict sales levels by identifying the underlying trend from a sequence of actual sales figures recorded at regular intervals in the past. To make sales forecasts more accurate, managers need to consider three different types of variations that affect the results of time series analysis:

  - *Seasonal variations* - These are periodic fluctuations in sales revenues during different times of the year (see Box 50.1).

  - *Cyclical variations* - These are recurrent fluctuations in sales revenues linked to the economic cycle of booms and slumps (see Figure 46.5). Unlike seasonal variations, cyclical variations can last longer than a year.

  - *Random variations* - These are unpredictable fluctuations in sales revenues caused by erratic and irregular factors that cannot be practically or reasonably anticipated (see Box 50.2).



Figure 25.2 - Sales forecasting is useful for predicting demand for seasonal goods such as winter coats

In practice, businesses are likely to use a combination of sales forecasting methods. The choice depends on several factors, such as:

Box 25.1 - Examples of seasonal demand

Seasonal fluctuations in demand are caused by variations in the demand for certain goods and services during different times of the year. Examples of seasonal demand include:

- Clothing (winter and summer seasons)
- Easter eggs
- Festivals, such as Christmas, Diwali, Easter, Lunar New Year and Ramadan
- Fireworks
- Flights (for holidays)
- Gift cards, such as Mothers' Day cards or Valentine's cards
- Sun lotion
- Sunglasses
- Textbooks.

Box 25.2 - Random variations

Examples of random variations that can disrupt sales forecasts include:

- Labour unrest, such as strike action (see Chapter 13)
- Mass-scale product recalls due to safety concerns and defects (see Chapters 37 and 40)
- Natural disasters, such as hurricanes, severe flooding, fires and earthquakes
- Outbreak of a war
- Outbreak of infectious diseases
- Political turmoil and public disorder
- Public relations disaster
- Unexpected, adverse weather conditions.

- Accuracy (how accurate the forecasts need to be) - The greater the degree of certainty needed, the more thorough the methods of sales forecasting need to be. For example, it is more meaningful to use monthly or quarterly data to forecast the sales of ice cream; using annual figures would not reveal seasonal fluctuations in demand. However, this also involves more time, so incurs higher costs.

- Time (how far ahead forecasts need to be) - It is relatively easy to forecast sales for the next day, week or month. However, to predict sales levels over the next several years

is much more ambitious. Extrapolation is only useful (accurate) if predictions apply to the near future.

- Cost (the availability and cost of data collection) - If there is widespread access to a wealth of information at no or very little cost, then this can make sales forecasting more accurate. However, if it proves difficult to find appropriate and up-to-date data and information or if access to information is highly expensive, this will affect the choice of forecasting methods.

- The stage in a product's life cycle - Market research rather than time series analysis will be used during both the 'Research and Development' and 'Launch' stages of the product life cycle (see Chapter 27). More data and information become available during the growth and maturity stages of a product's life cycle.

Case study 25.1 - The McBig Macstake

In 1998, McDonald's celebrated its 25th Anniversary in the UK by offering a Buy One Get One Free (BOGOF) deal on its best-selling product - the Big Mac. McDonald's doubled its supply of Big Macs for the special offer but failed to forecast the additional demand that the BOGOF deal would bring. Many of the McDonald's restaurants had sold out of Big Macs by 11am on the first day, upsetting customers across the country. The special promotion went on to become one of the biggest marketing mishaps in UK corporate history.

Business Management Toolkit

Statistical techniques are used in sales forecasting and analysis of sales forecasting data. Refer to Chapter 50 and determine how the use of the arithmetic mean, median average, modal average and standard deviation are used to improve sales forecasting.

Benefits and limitations of sales forecasting

The benefits and limitations of sales forecasting. AO3

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- *Improved working capital and cash flow* (see Chapter 20) - Sales forecasting can help a business to identify seasonal fluctuations in the demand for its products and hence the implications for the organization's liquidity position. If managers have a clear idea of expected costs and revenues, they are more likely to have better cash flow management in the coming months.

- *Improved stock control* - Accurate sales forecasts help to ensure that the correct levels of stocks are available for use in production at different times of the year. Holding excessive or insufficient inventory can be a disaster. Hence, sales forecasting helps managers to optimize their production planning (see Chapter 40).

- *Improved productive efficiency* (see Chapter 37) - The ability to plan for the correct level of production means better use of an organization's resources. For example, many retailers temporarily hire part-time staff during peak holiday trading periods due to the high seasonal demand. Accurate sales forecasting therefore allows managers to devote time to strategic planning to develop the business, rather than deal with operational problems caused by a lack of production planning (see Chapter 40).

- *Helps to secure external sources of finance* (see Chapter 15) - Accurate and realistic sales forecasting can help a business to obtain external financing from investors and commercial lenders. This is especially important for new businesses as sales forecasts are a common requirement in business plans (see Chapter 48).

- *Improved budgeting* (see Chapter 22) - Accurate sales forecasting helps managers to anticipate changes, such as seasonal variations and therefore to adjust budgets accordingly. For example, changes in sales trends (the buying habits of customers) make it easier for production managers to know how much inventory to hold and for marketing managers to know how many sales staff to hire at different times of the year.

HIGHER LEVEL



Figure 25.3 - Sales forecasting can help firms to predict peak trading times

Essentially, the benefits of sales forecasting should help managers to have better control by giving them informed expectations of the near future, thereby optimising their marketing and production plans. This enables the business to operate more efficiently and more profitably.

The limitations of sales forecasting (AO3)

- *Limited information* - Sales forecasting is a prediction based on historical data and trends. Sales forecasting does not reveal the whole picture (as the tool is based on assumptions), without any consideration of qualitative factors that affect actual sales. As sociologist William B. Cameron (1963) said, "not everything that can be counted counts and not everything that counts can be counted". Forecasts are only as good as the information and data that are available at the time the forecasts are made.

- *Inaccuracy of predictions* - Critics argue that sales forecasting is part fact and part guesswork. There can be an element of bias or subjectivity in sales forecasting. Even good sales forecasts are based on assumptions, such as the level of confidence in the economy. Whilst change might be inevitable, sales forecasts can be wrong for many reasons, such as managers being overly optimistic about the figures used and the forecasts made. Past trends are not indicative of the future. Having no or very limited historical data (because the product is new, for example) can make sales forecasting extremely difficult or inaccurate.

- *Garbage in, garbage out (GIGO)* - If the data and information used to predict sales forecasts are outdated, irrelevant or heavily biased, then the forecasts are unrealistic and of little or no value to management. For example, some managers might deliberately underestimate sales forecasts so that it is easier to reach their sales targets. Alternatively, some managers might overpredict their sales in an attempt to secure larger budgets.

- *External influences* - The external business environment (see Chapter 46) causes change that may not be predictable, such as natural disasters, oil price hikes, fierce competition from abroad, unexpected fluctuations in the business cycle or adverse weather conditions. No one could have predicted the widespread and prolonged impacts of the COVID-19 pandemic. Such factors can significantly distort sales forecasts.



Figure 25.4 - Sales forecasting can help firms to predict peak trading times

Exam tip !

Given that most new products fail to get established in the market, this implies that businesses often over-predict their sales. This means that sales forecasting is not an exact science and you need to be aware of the limitations.

Common mistake

Some students are often quick to condemn the skills of sales forecasters, stating that the data collected is either biased or unrepresentative. Sales forecasting techniques can be extremely sophisticated (beyond the scope of your IB exams) and give reliable data for marketers. Of course, if actual sales figures vary significantly from the forecasts, then questions should be asked; but don't assume that sales forecasts are unreliable simply because they don't match the predicted figures.

Question 25.1 - Ferdows Khatib Fabrics

The data below show monthly sales revenue ($'000) for Ferdows Khatib Fabrics for the last seven months of trading. The firm is attempting to make **sales forecasts** from its historical data.

Month	1	2	3	4	5	6	7
Sales	225	300	450	600	795	900	1,200

(a) Define the term *sales forecasting.* *[2 marks]*

(b) Explain **one** advantage and **one** disadvantage of sales forecasting for Ferdows Khatib Fabrics. *[4 marks]*

(c) With reference to the data, suggest why Ferdows Khatib Fabrics might need to be aware of seasonal or cyclical variations in its sales data. *[4 marks]*

Theory of Knowledge (TOK)

To what extent can history, as one of the five areas of knowledge, help managers and entrepreneurs to know about the future?

Theory of Knowledge (TOK)

To what extent can we know something if the knowledge claim is based on predictions?

Sales forecasting and the key concepts

Changes in the external business environment can quite easily affect the results of sales forecasting. For example, an economic downturn (recession) would have an adverse impact on sales forecasts for almost all businesses in the country. Multinational companies are also exposed to changes in exchange rates (see Chapter 46) which will therefore have an impact on their sales forecasts in overseas markets. Technological progress that helps reduce average production costs can help to boost sales revenue if average prices fall. Hence, with so many variables that can affect sales predictions, any change in these factors can alter the outcome of sales forecasts.

Changes in technology can positively affect sales forecasts. For example, product innovations such as smartphones and online apps have ensured Samsung and Apple enjoy the benefits of market leadership. In particular, the Internet has enabled many small businesses to reach markets that they were unable to access in the past. Whilst this change boosts sales revenue, it can make sales forecasting less accurate, at least in the short-term. Similarly, the globalization of markets can improve future sales revenues for a firm but make sales forecasting less precise.

Ethical considerations can also play a key role in sales forecasting. If predictions are made on subjective grounds, using unreliable data, then there are clearly ethical questions to be asked. Managers may overestimate sales forecasts in an attempt to sway decision making. For example, overpredicting sales forecasts may be used to secure financial backing from investors and commercial lenders. However, there are ethical implications of such practices; any strategy that depends too heavily on sales forecasts has added risks.

Sales forecasting can also be important for economic sustainability. Marketers can use sales forecast data to make decisions about expanding to overseas markets, for example, to sustain business growth. The most common basis for forecasting sales of new products is to rely on quantitative primary research data (see Chapter 26). This is usually combined with test marketing before launching a product to the market. Test marketing is a strategy that complements sales forecasting as a decision-making tool. It involves launching a new product to a selected panel of customers, often in a particular geographical location to gauge customer acceptance and responses to the new product (see Chapter 27). The data from test marketing can then be used to forecast sales prior to the product being

HIGHER LEVEL

launched nationally or internationally. Although this strategy can be rather expensive and produce unrepresentative results, it reduces the risks of product launches.

Business Management Toolkit

Discuss how the use of descriptive statistics (see Chapter 50) and simple linear regression (see Chapter 58) can help a business to improve the accuracy of its sales forecasting.

Key concept

With reference to an organization of your choice, examine how **creativity** affects its ability to **change** and evolve.

REVIEW QUESTIONS

1. What is meant by sales forecasting?
2. What are the main benefits of sales forecasting?
3. Why might sales forecasting techniques be inaccurate?
4. What are the main limitations of sales forecasting?
5. How might changes in the external environment influence sales forecasting?

KEY TERMS

Cyclical variations are recurrent fluctuations in sales revenues linked to the economic cycle of booms and slumps.

Sales forecasting is a quantitative management technique used to predict a firm's level of sales over a given time period.

Seasonal variations are periodic fluctuations in sales revenues during different times of the year.



Figure 25.5 - The demand for umbrellas is dependent on seasonal variations

Random variations are unpredictable fluctuations in sales revenues caused by erratic and irregular factors that cannot be reasonably anticipated.

Time series analysis is a sales forecasting technique that attempts to predict sales levels by identifying the underlying trend from a sequence of actual sales figures.

Chapter 26
Unit 4.4 - Market research

"Those who have knowledge don't predict. Those who predict don't have knowledge."
- Lao Tzu (604BC - 531BC), Chinese philosopher

Contents

4.4 Market research	
SL/HL content	**Depth of teaching**
Why and how organizations carry out market researchs	AO3
The following methods/techniques of primary market research: • surveys • interviews • focus groups • observations	AO2
The following methods/techniques of secondary market research: • market analyses • academic journals • government publications • media articles • online	AO2
The difference between qualitative and quantitative research	AO2
The following methods of sampling: • quota • random • convenience	AO2

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Why and how organizations carry out market research (AO3)

Market research refers to marketing activities designed to discover the opinions, beliefs and preferences of potential and existing customers. Essentially, market research serves to identify and anticipate the wants and needs of customers, usually in a profitable way. Market research can also involve collecting data and information about competitors and market trends to gain insight into a specific industry. Market research can be ad hoc or continuous:

- **Ad hoc market research** takes place on an 'as and when necessary' or one-off basis. The focus of the research is on a specific marketing problem or issue at a particular point in time.

- **Continuous market research** takes place on a regular and on-going basis. For example, governments usually calculate the cost of living based on the price data of a representative sample of products bought by the average household. Market research firms report annual league tables containing information such as the most popular brands in a certain country or region. The movie and music industries compile weekly 'Top 10' lists based on sales figures.

The purpose of market research include:

- Giving businesses up-to-date information. This is particularly important in fast-paced industries that are always changing, such as the high-fashion and consumer electronics industries.
- Enabling businesses to improve their marketing strategies by using a distinct marketing mix for each market segment or target market.
- Assessing customer reactions to a new product by testing it on a small group of customers (focus groups). This can prevent huge losses had the product been unsuccessfully launched on a national or international scale.
- Giving businesses a better understanding of the various activities and strategies used by their competitors.
- Helping businesses to predict what is likely to happen in the future. Understanding the likely trends will enable businesses to react more accordingly in order to take advantage of future opportunities.

Effective market research helps to reduce the risks of failure, by investigating the latest needs, preferences and desires of customers. If the market research findings show that customers react negatively to the product, then the business can either make necessary changes or abandon the project altogether (without having to spend huge amounts of money on a national launch, for example). Market research can therefore be used to establish answers to questions such as:

- Are customers likely to buy the product?
- Which market segments are interested in the product?
- How much are customers willing to pay for the product?
- How often are they likely to purchase the product?
- Which brands do customers see as being the main rivals to the marketed product?
- What are the preferred (most effective) methods of advertising and promotion?
- Where and how should the product be sold?

Ultimately, as a strategic planning tool, market research helps businesses to reduce risks. Being able to accurately forecast future market trends gives businesses a greater chance of success, despite the limitations of market research.

Exam tip !

Read this unit before embarking on your Internal Assessment (IA). Market research is a vital part of the IA process in Business Management. You are required to use three to five supporting documents which can be based on primary and/or secondary research for a real-life organization that faces a specific problem or issue. The source documents must be appropriately selected for their suitability, depth and breadth in order to answer the research question.

Primary market research (AO2)

The following methods/techniques of primary market research: (i) surveys, (ii) interviews, (iii) focus groups and (iv) observations. AO2

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Market research can be conducted in two broad ways - as primary market research and secondary market research.

Primary market research involves gathering new and first-hand data for a specific purpose. For example, if an organization wants to know how employees feel about the working environment, then it would use primary market research. Primary market research (also known as **field research** or **bespoke research**) is often used to gather data and information from customers to identify their buying patterns and to anticipate changes in market trends. The general advantages and disadvantages of primary market research are outlined in Table 26.1.

Table 26.1 - The advantages and disadvantages of primary research

Advantages of primary research	Disadvantages of primary research
Relevance - Primary market research is carried out for a specific purpose, so directly addresses the questions that need to be answered. By contrast, secondary data is not always in a format that is useful or usable for the business.	*Time consuming* - It can be a very tedious and lengthy task to collect primary research data that are accurate and representative. This can delay decision-making and could lead to lost market opportunities in the short-term.
Up to date - Secondary market research data tends to be more dated and therefore often less reliable than primary research findings.	*Costly* - Collecting primary data is often costly, due to the time involved to gather sufficient and meaningful data or because data is collection is difficult.
Confidential and unique - As the market research is conducted first-hand, no one else (including competitors) has access to the information.	*Validity* - Flaws in market research (such as poor questionnaire design or sampling errors) will lead to misleading, incomplete and biased results.

Common mistake

Students often assume that primary market research is always conducted by the business itself. However, due to the limitations of primary market research, many businesses hire specialist market research agencies to conduct the bespoke research on their behalf.

There are several methods of conducting primary research, including: (i) surveys, (ii) interviews, (iii) focus groups and (iv) observations.

(i) Surveys

A **survey** (sometimes referred to as a **questionnaire**) is a document that contains a series of questions used to collect data for a specific purpose. This is the most common method of primary market research. There are several types of surveys, such as:

- *Self-completed surveys* are done by individual people to provide feedback and comments to the researcher. For example, many hotels and restaurants use these to gather the views from their guests and diners. The information can help the business to identify problems, trends and suggestions for improvement.

- *Personal surveys* are conducted face-to-face, rather like an interview. The interviewer can address any questions that might arise from the survey (such as clarifying what certain questions mean). It is also quicker for interviewers to complete the survey due to their familiarity with the questions and purpose of the survey.

- *Telephone surveys* are similar to personal surveys but use telecommunications technology. The benefit of this method is that a larger number of people in a wider geographical spread can be covered. The main drawbacks are the relatively higher costs and the low response rate (as a large number of people are not willing to take part in telephone surveys).

- *Online surveys* such as SurveyMonkey or Google Forms are an increasingly popular way of gathering primary market data. For example, many schools use online surveys to find out the views of staff and students on a range of issues, such as getting feedback on school uniform and teacher training courses. They are much cheaper than other forms of primary market research such as paper-based surveys or telephone surveys. Computer software can also help researchers to collate quantitative research data, thereby saving a lot of time and resources.

- *Postal surveys* are sent to people's home or office address for them to complete in their own time. A drawback of this method is that people might simply treat the surveys as junk mail, so ignore them. To create an incentive for people to return postal surveys, businesses often provide free postage (the business pays for this) or offer prizes and gifts (but this clearly adds to the firm's costs). Another limitation is the time delay between posting surveys to potential respondents and receiving the completed forms.



Figure 26.1 - Time lags with the post means postal surveys are less popular than online surveys

Due to the potential benefits of using surveys as well as the potentially high costs, effective survey design is of real importance. Therefore, surveys should:

- Avoid *bias* in order to collect meaningful and useful data. For example, the wording of questions should not intentionally distort answers from respondents, such as asking people how much they like Coca-Cola rather than asking them which brand of cola they prefer.
- Avoid *jargon* (technical language) so that respondents fully understand the questions. This helps to minimize potentially misrepresentative responses.
- Include both *closed* and *open-ended questions*. Closed questions (such as 'yes or no' questions or multiple-choice options) make it easier and quicker to complete a survey. They also facilitate quantitative analysis. Open-ended questions allow the researcher to obtain qualitative answers, such as the reasons why respondents prefer a particular option. They can also provide ideas or suggestions that enable the business to make more informed decisions.
- Be *tried and tested*. Before using a survey for market research, it is common for it to be trialled (tested) with a

CORE

Marketing

Question 26.1 - Questioning Questionnaires

Study the survey below and answer the questions that follow.

Survey Research

Is it feasible to open another branch of Pawlyn Greetings Cards in Kennedy Town Centre?

1. Name .....

2. Age: Under 10 ☐ 10–15 ☐ 15–25 ☐
26–35 ☐ 36–64 ☐ 65+ ☐

3. Gender:

4. Where do you live? .....

5. Do you shop in Kennedy Town Centre? ..... **6.** How often? .....

7. Do you shop in Pawlyn Greetings Cards? ..... **8.**Why? .....

9. What item(s) do you buy there? .....

10. If a new Pawlyn Greetings Cards store were to open in Kennedy Town Centre, would you use it? Yes ☐

Thank you!

(a) With reference to the survey above, distinguish between quantitative and qualitative primary market research. *[4 marks]*

(b) Describe **three** ways to improve the above survey. *[6 marks]*

small group of people. This can help to identify any errors or omissions in the initial survey so that the results from the final research better serve the needs of the researcher.

- Allow the *objectives* of the survey to be met by gathering only relevant data. For example, unnecessary questions should be avoided (those that result in superficial findings and impractical recommendations) and the length of the survey should be limited as far as possible.

A major advantage of using surveys is the ability to generate quantitative and qualitative answers specific to the needs of the researcher. If designed properly, they can also be very simple to complete thereby making the process easier to gather market research data. However, using surveys for market research can be very costly and time-consuming as it is necessary to use a large enough sample to get statistically representative findings. There might also be reservations about the results due to bias or dishonest answers from some respondents.

Theory of Knowledge (TOK)

Given the complications of survey designs and sample sizes, can primary market research data ever be truly reliable?

(ii) Interviews

Interviews involve one-to-one discussions between an interviewer and interviewees, such as individual customers, to investigate their personal circumstances and opinions. Beliefs, attitudes and feelings can also be explored in detail. Interviews are usually carried out in person (face-to-face), although telephone and online interviews can also be used. The findings from all interviews are analysed to identify the views that respondents share. Identifying the differences can also be important as it can help a business to refine its marketing strategies. In-depth interviews are often used when a business is planning to introduce change and new initiatives as they can be used to investigate the views of respondents to a new proposal.

However, interviews often provide a range of non-quantifiable information that might prove to be difficult to analyse or to make any extrapolations from. In addition, interviews can be extremely time consuming to plan, conduct and analyse. There is also huge scope for interviewer and interviewee bias, which can have an impact on the way in which respondents answer and how the results are therefore interpreted.

(iii) Focus groups

Focus groups involve forming small discussion groups to gain insight into the opinions, attitudes and behaviours of respondents. The group is typically made up of participants who share a similar customer profile, such as young adults who regularly play online computer games.

They can provide important information to help a business to devise and refine its marketing strategies. For example, focus groups are often used when a business plans to launch a new product. The focus group might be asked to discuss the merits of alternative adverts or give feedback on the prototypes of a product. By using a focus group, detailed questions can be asked and participants are more likely to engage in discussions to generate insightful information. To aid market research analysis, audio-visual recordings of the discussions and observations of the behaviour of the participants are often used.



Figure 26.2 - Focus groups help to provide important information from targeted consumers

Members of a focus group are often used for regular, ongoing market research. By using the same group, it saves the business from having to find new respondents. Also, as the participants are targeted consumer groups, such as food critics (food tasters), they are particularly useful for conducting market research that requires specialist knowledge rather than using a random sample. For example, prior to launching new models, car manufacturers often use consumer panels formed by a focus group of loyal and knowledgeable customers.

One drawback of using focus groups is that only extroverts tend to take part; those who shy from group discussions and debates are unlikely to participate and therefore their views are not acknowledged or represented. In an open forum, there might also be some pressure for focus group members to conform to the majority view rather than to express their personal opinions. Another potential limitation is that participants often have to be paid, either in cash or in lieu (such as a meal voucher) for

their time and input. This expense raises the overall costs of using focus groups for market research.

(iv) Observations

This method of primary market research involves watching how people behave and respond in different situations. It can be done under controlled conditions (rather like a laboratory test) or as real-life situations (where people do not know that they are being observed). Observations can be carried out using surveillance filming, photographic evidence or in person (by using a checklist or pre-designed observation form). Traffic audits, for example, are used to measure the flow of traffic on certain roads or in certain locations. Observations are often used by businesses such as restaurants, theme parks, banks, health clinics, call centres and the post offices in order to measure the average time it takes to serve a customer (queuing times).

A benefit of using observations is that they record people's actual behaviour rather than what people say they would do in a particular situation (as in the case of interviews and surveys). However, observations do not necessarily reveal why a person behaves or responds in the way they do. The only way to establish the reasons behind a person's motivation is to ask them, either in a direct or indirect way.

Key concept

Discuss the potential **ethical** issues that arise from the use of primary market research methods such as observations.

Theory of Knowledge (TOK)

How might the language used in primary market research techniques influence the knowledge claims that are reached?

Secondary research (AO2)

The following methods/techniques of secondary market research: (i) market analyses, (ii) academic journals, (iii) government publications, (iv) media articles and (v) online. AO2

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Secondary research (or desk research) involves the collection of second-hand data and information that already exists. This means that the data and information have previously been gathered by others, such as government publications or news articles. The generic advantages and disadvantages of using secondary market research are shown in Table 26.2.

CORE

Marketing

Question 26.2 - Zaffran Craftphoria

Wahida Mostafa runs a small business called Zaffran Craftphoria in Dhaka, Bangladesh. The business sells craft products such as table mats, coasters, bags, table runners and embroidered pencil cases. These products are hand made by Wahida. She is keen to get customer feedback on the appeal and quality of her products by using **primary market research**. Zaffran Craftphoria has recently launched a Facebook website.

(a) Define the term *primary market research*. *[2 marks]*

(b) Explain the value of primary market research to small businesses such as Zaffran Craftphoria. *[4 marks]*



Source: www.facebook.com/zcraftphoria

Table 26.2 - The advantages and disadvantages of secondary research

Advantages of secondary research	Disadvantages of secondary research
If the data or information already exists, it is generally cheaper and faster to collect and analyse rather than primary market research that has to be designed and collected.	Secondary data is second-hand data, so the information might already be outdated or can become obsolete quite quickly, such as SWOT analyses (see Chapter 44) for the organization.
It can provide an insight to changes or trends in an industry, such as whether customers are spending more money on household goods, jewellery and tourism. This allows firms to develop strategies in response to these market changes.	The data or information might be in an inappropriate format for the researcher as they have been collected for another purpose. Hence, the research needs to be further adapted or manipulated to suit the specific needs of the business.
There is a huge range of secondary sources that market researchers can use, especially with online sources. This makes secondary research data usually more accessible than primary research data.	Secondary research might only provide partial information as it was produced for a different purpose. This means the information does not address all the questions sought by the researcher.
Findings are often based on large sample sizes and thorough research techniques, so the results are statistically valid.	Unlike primary research, the data and information from secondary market research are also available to competitors.

Secondary market research can be collected from internal and external sources. **Internal sources** are those that have already been gathered by the organization itself, such as company annual reports and sales records. **External sources** come from outside the business, such as market analyses, academic journals, government publications and media articles (including the Internet).

(i) Market analyses

A market analysis reveals the characteristics, trends and outlook for a particular product or industry, such as market size, market share and market growth rates. It can help to measure how well a business is doing compared with its competitors in the market. New businesses often rely on market analyses to formulate their business plans (see Chapter 48). Market analysis data and information can be found in commercial sources and public information sources, such as:

- Market research firms - Specialist market research firms supply a large range of market analyses, usually only accessible to subscribing clients. Examples include Nielsen, Mintel, Euromonitor and J.D. Power & Associates (see Question 24.5).
- Competitors - Company annual reports and websites of competitors are easily accessible and could provide a wealth of data and information for researchers.
- Trade publications - These are specialist publications targeted at a specific industry. For example, *The Grocer* is a popular trade magazine used in the supermarket industry. Many teachers of Business and/or Economics around the world subscribe to the *Economics, Business and Enterprise Association (EBEA)*, which publishes the latest trends and thinking in these subjects.



Figure 26.3 - The EBEA (https://ebea.org.uk/) is an example of a trade publication

The main advantage of using market analyses is that they enable businesses to access relevant up-to-date and detailed market data, trends and forecasts. However, it can be very expensive to use market analyses, as they usually have to be paid for. For example, most of the data and analyses on Statista are only available to subscribers who have paid for the service. In addition, data and information from market analyses can become outdated quickly, unless the source provides regular and ongoing updates.

(ii) Academic journals

Academic journals are periodical publications from educational and research institutions. Data and information relating to a particular academic discipline are published in these journals. For example, the Harvard Business Review is a globally recognised Business Management magazine from Harvard University. Academic journals publish educational, peer-reviewed articles and findings written by industry experts

and academics. The main purpose is to distribute and share theoretical work and market research findings, rather than to sell the information for profit.



Figure 26.4 - IB Review is an academic journal for IB educators and Diploma students

Box 26.1 - Business Management theories and academic journals

Examples of Business Management theories in the IB syllabus that first appeared in academic journals include the following:

- Adams' equity theory, Journal of Abnormal Psychology (1963)
- Ansoff matrix, Harvard Business Review (1957)
- Herzberg's two-factor theory of motivation, Harvard Business Review (1968)
- Lewin's force field analysis, Psychological Review (1943)
- Maslow's hierarchy of needs, Psychological Review, Princeton University (1943)

Exam tip !

If you are writing a Business Management Extended Essay, consider the use of academic journals. Using these as secondary sources can certainly help to add academic rigour and perspectives to your essay. Doing so can also help with Criterion A (Focus and Method).

An advantage of using academic journals is that the articles contain the most up-to-date research in an academic discipline. The source is likely to be the most reliable as it has been authored by academic scholars in a rigorous way. For example, the articles will have been proofread and checked by academic peers and editors.

However, disadvantages include the fact that information or data are not always relevant to the researcher and can become outdated quickly. The findings are often contestable (see TOK question below). Also, universities and academic establishments tend to charge users to access their academic journals.

Theory of Knowledge (TOK)

When does academic research become accepted as knowledge?

(iii) Government publications

Governments publish a broad range of data, such as population censuses, social trends, labour market developments, trade statistics, unemployment figures, inflation rates and so on. Government websites (such as www.statistics.gov.uk and www.usa.gov) are a popular source of secondary market research data.

The main advantage of using government publications is that the data and statistics are usually comprehensive, reliable and up-to-date. In addition, government publications cover a wide range of topics, thus providing researchers with a wealth of data, statistics and information. Also, many government publications are available free of charge.

However, the main disadvantage of government publications is the challenge in identifying and locating the information required, due to the vast amount of information available. There is often a fee for researchers to obtain specialist and detailed information from government publications.

Exam tip!

These two websites contain data from governments, which could prove to be extremely useful for your Internal Assessment and/or Extended Essay:

- Trading Economics (www.tradingeconomics.com)
- CIA World Factbook (https://www.cia.gov/the-world-factbook

(iv) Media articles

The general and mass media can contain valuable data and information as part of secondary market research. Media articles are text publications written about a specific topic. Examples of media articles include:

- Newspapers, such as the *Financial Times* and the *Wall Street Journal.*
- Commentaries and articles in business-related publications, such as *The Economist*, *Forbes* and *Bloomberg Businessweek*.
- General business books, such as biographies, autobiographies and publications about specific companies, entrepreneurs or business management topics (such as corporate social responsibility).

As media articles are released very frequently, a major advantage for researchers is that the data and information are up to date at the time of publication. With advances in digital and mobile technologies, many media articles can be found online without people needing to take out a subscription to access such resources (a lot of this is funded by advertising revenues). So, media articles enable researchers to have easy access to a wide range of up-to-date information, without necessarily paying for this.

However, a disadvantage is the potential bias from the reporters, journalists and authors of the media articles. Also, the articles can become out of date quite quickly and therefore irrelevant, rather quickly. Finally, many media articles require users to have a paid subscription in order to access the information. This can therefore be a costly source of secondary market research data and information.

(v) Online

All of the above methods of secondary market research (market analyses, academic journals, government publications and media articles) are increasingly available online via the Internet. Many people start their secondary market research by 'Googling' the topic or using other online sources such as Wikipedia. Google is by far the world's most used search engine, with over 90% market share. Wikipedia is the world's largest online encyclopaedia.



Figure 26.5 - Google is the world's most used search engine

The Internet can provide a range of invaluable information, if not a good starting point to find other sources of secondary market research data and information. Online providers of secondary market research data and information often charge for their services, although careful and tactful use of the Internet can reap plenty of useful information without cost to the researcher, such as company websites, blogs and social media forums. Unlike print media, online sources can benefit from the inclusion of audio-visual engagement, such as documentaries like *Super-Size Me, An Inconvenient Truth, Freakonomics* and *Food, Inc.*

A major advantage of using online sources is that they are readily available, 24 hours a day, every day. With advances in Internet technologies, researchers have access to websites and apps of countless businesses, large newspaper companies and news broadcasters from across the world. In addition, the growing popularity of social media and social media marketing (see Chapter 29) allows news to be easily spread and shared via social networks (such as Facebook, Instagram, LinkedIn, Twitter and WhatsApp).

Exam tip !

If you are writing a Business Management Extended Essay, make sure you use an appropriate range of secondary market research. This can be supplemented, where appropriate, by use of primary market research.

In reality, it is common for market researchers to use both primary and secondary data and information. This is because neither method is necessarily better than the other as it depends on what data or information a business needs to collect. Secondary market research is generally quicker and cheaper to gather but might be out of date or might not be sufficiently appropriate. Primary market research findings could contain bias or errors but can provide information not available through secondary data sources.



Figure 26.6 - Market researchers use a combination of primary and secondary methods of research

The difference between qualitative and quantitative research (AO2)

In addition to classifying market research as primary or secondary methods, market research can also be categorized as qualitative or quantitative.

Qualitative market research involves getting non-numerical answers and opinions from research respondents. It is commonly used as part of primary market research but can feature in secondary market research. The main purpose of using qualitative data is to understand the behaviour, attitudes and perceptions of customers, employees or other respondents. 'Soft' answers (people's views/opinions rather than hard facts/figures) are sought by the researcher. This might be done by using in-depth interviews or by asking open-ended questions. The two main types of qualitative research methods are focus groups and in-depth interviews. The main advantages and disadvantages of qualitative research are outlined in Table 26.3.

Theory of Knowledge (TOK)

How important are the opinions of market researchers in the search for knowledge?

CORE

Table 26.3 - The advantages and disadvantages of qualitative research

Advantages of qualitative research	Disadvantages of qualitative research
It is better than quantitative research for exploring the driving forces (motivators) and restraining forces (demotivators) concerning the behaviour and attitudes of respondents.	Due to the small sample size typically used in qualitative research, the findings might not be representative of the whole population. Further research might therefore be necessary.
Information gathered from qualitative research can be very valuable. Unlike the use of surveys, there is flexibility in the process so extra and useful information from in-depth interviews can be gathered.	It can be very time consuming to conduct and to interpret the findings. Quantitative responses are easier and quicker to collate than qualitative responses. So, analysis of the results can be rather limited.
Due to the low number of respondents involved in qualitative market research, it can be inexpensive yet provides detailed information to the researchers.	A high level of interviewing expertise is required to engage and encourage respondents. The costs of hiring skilled interviewers can therefore be high.
With one-to-one interviews, respondents are not under the pressure of conforming to the views and opinions of the majority. This should help to generate more honest and representative answers.	Interviewer bias might be introduced to serve the researcher's own purpose (to deliberately skew the results). Hence, the validity of the findings from qualitative market research can be questionable.

Quantitative market research relies on a much larger number of responses to get 'hard' answers (factual and measurable information rather than people's views or opinions). Like qualitative market research, it involves using a representative sample to gauge the views of the population. Two quantitative techniques found in primary market research (such as surveys and questionnaires) are:

- *Closed questions*, which allow respondents to choose from a given list of options, such as gender, age range, income level, true or false questions and multiple-choice options.
- *Likert scales* or *sliding scales*, which are used to ask respondents to rank options, such as the extent to which they agree with a given statement (using a scale from 'strongly agree' to 'strongly disagree').

The use of secondary market research methods can also supply a wealth of quantitative data, such as market share, sales trends and profitability or forecast changes in consumer income levels.

The advantages and disadvantages of quantitative market research are the opposite of those for qualitative methods, as outlined above. For example, quantitative market research methods do not have the flexibility of qualitative methods because pre-set questions are used. However, as the findings can be collated and represented numerically, the results are usually easier to analyse.



Figure 26.7 - Surveys can provide both quantitative and qualitative responses

Theory of Knowledge (TOK)

At what point does market research generate *new* knowledge, if at all?

CORE

Question 26.3 - Toys 'Я' Us

Prior to its bankruptcy in 2018, Toys 'Я' Us was the world's largest toys retailer, with over 1,640 stores and global annual sales of $14bn. It sold toys based on classics, such as Barbie dolls, as well as the latest trends including Star Wars products and Disney merchandise. Despite the toy industry being massive, the high costs of rent and the preference of customers switching to online retailers such as Amazon, caused Toys 'Я' Us to collapse. Only a few franchised Toys 'Я' Us stores remain open today.



A recent CNN report showed that Americans spend around $250bn a year on toys - and that's just the figure for children aged between 8 to 12 years (known as preteens or 'tweens'). Toy manufacturers and retailers are often keen to research the television programmes and movies watched by children and the magazines that they read.

(a) Explain why toy retailers might be interested in the television programmes or magazines viewed by children. *[4 marks]*

(b) Examine how market research can allow businesses, such as toy retailers, to differentiate themselves. *[6 marks]*

Marketing

Sampling methods (AO2)

The following methods of sampling: (i) quota, (ii) random and (iii) convenience. AO2

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All the potential customers of a particular market make up what researchers call the **population**. Since a market can comprise thousands, millions or even billions of potential customers, businesses lack the time and resources to conduct market research on every person in the population. Besides, statisticians argue that this would be unnecessary to get statistically valid results. Instead, a **sample** of the population is selected for market research purposes. **Sampling** is a primary research technique that selects a small group (called a **sample**) of the population from a particular market for research purposes.

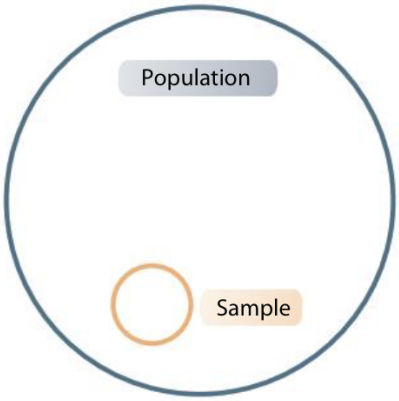

Figure 26.8 - Samples from the population are used for market research

The key questions to ask when deciding on the type of sampling method to use are who needs to be asked, what needs to be asked and whether the cost can be justified. The 'best' sampling method will require research from a large enough sample size to generate representative findings. The three sampling methods in the syllabus are: (i) quota sampling, (iii) random sampling and (iii) convenience sampling.

(i) Quota sampling

Quota sampling is the most commonly used sampling method, whereby a certain number of people (known as the quota) from different market segments is selected. The sample is grouped according to shared characteristics such as age, gender or occupation. For example, in an organization with 1,000 people, a researcher might want to interview 50 employees and 5 senior managers about specific work-related issues.

An advantage of using quota sampling is that a relatively representative sample can be obtained quickly. Also, the findings are more reliable than simply asking anyone on a random basis to participate in the market research.

The main disadvantage of quota sampling is that the number of people interviewed in each segment and how randomly they are chosen for interview, are not always representative of the population. For example, if a researcher had a quota of 100 female customers to interview, then the first 100 women might be asked to take part in the market research, without considering whether these respondents are representative of the population. **Sampling errors** are therefore likely to occur since not everyone gets an equal chance to be part of the market research. Sampling errors are caused by mistakes made in the sample design, such as an unrepresentative sample being used or the sample size being too small to get statistically valid findings.

(ii) Random sampling

Random sampling involves giving everyone in the population an equal chance of being selected. The respondents are often randomly chosen by a computer using information from a database. Random sampling is useful when all members of a population have the same or very similar characteristics. For example, airline companies might use this method to get feedback from their passengers on economy, business and first-class travel. Parents of children in a school may be randomly selected to get their feedback on school-related matters such as school uniform and the quality of home learning activities.

An advantage of using random sampling is that it is quite easy to get a sufficient sample. Also, everyone has an equal chance of being selected so this might help to minimise potential bias or unrepresentative samples being selected (as can be the case with quota sampling).

The main drawback of random sampling is that it is indiscriminate, i.e. it might select people who are not part of the target group due to the randomness of selection. Therefore, sample sizes need to be large enough to get representative and meaningful results. However, this can be both time-consuming and expensive.

(iii) Convenience sampling

Convenience sampling uses research subjects that are easy (convenient) to reach. For example, students often use their classmates and friends in a research study. A news reporter might conveniently interview passers-by in a shopping mall or on the street. Convenience sampling relies on ease of reach and volunteers because of their availability.



Figure 26.9 - Busy shopping areas are ideal for convenience sampling

The main advantage of convenience sampling is the ease (availability and the quickness) of data collection. It is particularly useful when time and cost are key factors for market researchers or if they want to quickly determine whether further market research is necessary.

However, the main disadvantage is that market researchers inadvertently exclude a large proportion of the population by using convenience sampling, thus the findings are often highly skewed and unrepresentative of the population. For example, a study conducted during a weekday afternoon to determine the average amount that customers spend at a restaurant is unlikely to give the same results as if the study was conducted during the weekend or a public holiday.

Exam tip !

All sampling methods have their limitations. There is always the risk that a sample does not truly represent the population, whichever method is chosen. Sampling errors (such as bias or an inadequate sample size) will hinder the validity of the findings. The 'best' method of sampling for a business depends on its size, financial resources, the purpose of its market research and the extent to which customers have homogeneous or heterogeneous tastes. It is important, as always, to put your answers into the context of the business.

Market research and the key concepts

The pace of change in many industries has fuelled the need for more effective market research. The dynamic nature of change means marketers have to rethink the way they conduct market research. Even established brands have to adapt to change - think about the decline of previous market leaders such as Blockbuster (video rentals), Motorola and Nokia (mobile phones), Kodak (camera film), Toys 'Я' Us (toys) and MySpace (social media). These were all brand leaders that dominated their markets but have been challenged by new entrants and business models that have changed the corporate landscape. Hence, in a world of continual yet erratic and unpredictable change, market research must adapt in order to allow businesses to know what and how things are evolving.

Creativity also influences market research. With developments in social media platforms and the spread of international marketing (see Chapter 34), marketers are spending an increasing amount of time and resources trying to understand what appeals to customers by using aspects of management information systems such as data analytics and big data (see Chapter 43). Using data, such as the spending habits of customers, can help businesses to better understand their customers and to adapt their marketing strategies more appropriately.

There are potentially huge ethical issues too surrounding the practice of market research. Marketers may be questioned about whether their research methods comply with an ethical code of conduct within the organization or society as a whole. In compliance with corporate social responsibility (see Chapter 3), the collection, processing and maintenance of personal data

need to be carried out in an ethical manner. With advances in internet technologies, it is easier than ever before for businesses to connect directly with their customers and to collect research information for future marketing purposes. Passing on personal data to third parties (often by selling the data) without consent is generally regarded as unethical business practice. Apple, Barclays, Facebook and Google have all be sued in recent years for allegations of selling personal data without consent. The use of photography or visual recordings for primary market research can also be perceived as an invasion of privacy, especially if used inappropriately.

Ethical market research requires researchers to be reasonable, objective and accurate in the process of planning, collecting, processing and reporting research information. Unethical market research can be remembered by the 5Ds©. These form the guiding principles to avoid when carrying out market research.

- **Damage** - Market researchers must protect research participants by ensuring the information collected is never used in a way that might harm them. The contents of an interview, for example, should be kept for research purposes only and not shared with other parties, which could damage relationships and trust. Instead, researchers should be open and transparent about how the research data will be used. Nothing should be shared without the prior knowledge and approval of research participants.

- **Dishonesty** - Market researchers need to be trustworthy in their attempt to obtain usable data for marketing purposes. They must avoid distorting data to misrepresent research findings. Plagiarism and the lack of referencing of secondary market research is also regarded as dishonest and unethical. In some countries, dishonest practices are not only unethical but may also be regarded as fraudulent and unlawful.

- **Deception** - Deceptive practices and misleading research methods to access and gather data about customers is unethical problem. Examples include not telling customers that their telephone interview is being recorded, that surveillance (hidden) cameras are being used for market research purposes or that information is being collected when customers browses a company's website.

- **Disclosure** - A major ethical issue involved in market research is the potential invasion of privacy and the breach of confidentiality. Researchers have the ability to collect, store, match and disclose (share and/or sell) customer information that can infringe a customer's privacy rights. Third parties might use this information to target customers with direct marketing materials (such as spam or junk mail). Any unauthorized disclosure of customer information is unethical.

- **Detachment** - Market researchers need to be detached from personal biases in their work. Marketing activities can have a huge impact on public perceptions. Bias and prejudgments skew the conduct of market research, thus cause distorted results. For example, deliberately asking misleading questions in a survey will mean unrepresentative data are collected.

It is equally important to remember that research respondents are not always honest in their own responses to certain market research questions (such as their age, income level or their ability and willingness to pay certain prices for a product). Cultural differences and people's suspicions of the intention of market researchers might also affect the responses given.

Key concept

With reference to an organization of your choice, discuss how market research has influenced **change** in its corporate strategy.

Key concept

Discuss the role of **ethics** for researchers conducting both primary and secondary market research.

Business Management Toolkit

Discuss the importance of primary and secondary research as part of the construction of an effective business plan (see Chapter 48) used to determine the commercial feasibility of the commercial idea or business proposition.

Business Management Toolkit

Discuss the importance of Hofstede's cultural dimensions (see Chapter 54) for the planning, implementation and analysis of the findings of primary and secondary market research.

REVIEW QUESTIONS

1. What is market research?
2. How does ad hoc market research differ from continuous market research?
3. What are the purposes of market research?
4. What is primary market research (field research)?
5. What is secondary market research (desk research)?
6. What are the main advantages of primary market research?
7. What are the main disadvantages of primary market research?
8. How do surveys differ from interviews?
9. How do focus groups differ from observations as forms of primary market research?
10. What are the main advantages of secondary market research?
11. What are the main disadvantages of secondary market research?
12. What are market analyses?
13. How do media articles differ from academic journals?
14. What are some examples of online sources as a form of secondary market research?
15. What are government publications and why might market researcher use these?
16. What are the differences between quantitative and qualitative market research?
17. How do open question differ from closed questions?
18. What is sampling and why do market researchers use it?
19. What are the differences between quota, random and convenience sampling methods?
20. What are the ethical issues that market researchers should take into consideration?

KEY TERMS

Academic journals are periodical publications from educational and research institutions that publish data and information relating to a particular academic discipline.

Ad-hoc market research is market research conducted as and when required in order to deal with a specific problem or issue.

Continuous market research is market research conducted on an ongoing basis, rather than a one-off (ad-hoc) basis.

Convenience sampling uses research participants who are easy (convenient) to reach. It relies on the ease of reach because of the convenient availability of volunteers.

Focus groups involve forming small discussion groups to gain insight into the attitudes and behaviour of respondents. The group is typically made up of participants who share a similar customer profile.

Government publications are a type of secondary market research, referring to official documents and publications released by government entities and agencies.

Interviews are a type of primary research that involve discussions between an interviewer and interviewees to investigate their personal circumstances, preferences and opinions.

A **market analysis** is a form of secondary market research that reveals the characteristics, trends and outlook for a particular product or industry, such as market size, market share and market growth rate.

Market research refers to marketing activities designed to discover the opinions, beliefs and preferences of potential and existing customers.

Media articles are a type of secondary market research referring to the documents (articles) in print or online media. They are written by skilled journalists and authors.

Observations are a method of primary research that involves watching how people behave or respond in different situations.

Online secondary market research refers to sources available on the Internet for research purposes. These include media articles, government publications, academic journals and market analyses available on the Internet.

The **population**, in marketing terms, refers to all potential customers of a particular market.

Primary market research involves gathering new data for a specific purpose, using methods such as surveys, interviews, focus groups and observations.

Qualitative market research involves getting non-numerical responses from research participants in order to understand their behaviour, attitudes and opinions.

Quantitative market research is about collecting and using factual and measurable information rather than people's perceptions and opinions.

Quota sampling involves using a certain number of people (known as the quota) from different market segments for primary market research purposes.

CORE

Random sampling gives everyone in the population an equal chance of being selected for the sample.

A **sample** is a selected group or proportion of the population used for primary market research purposes.

Sampling is a primary research technique that selects a sample of the population from a particular market for research purposes.

Sampling errors are caused by mistakes made in the sample design, such as an unrepresentative sample being used or the sample size being too small.

Marketing

Secondary market research involves the collection of second-hand data and information that already exists, previously gathered by others, such as media articles and government publications.

A **survey** is a document that contains a series of questions used to collect data for a specific purpose. Surveys are the most common method of primary research.



Figure 26.10 - Surveys are a form of primary market research

Chapter 27

Unit 4.5 - The seven Ps of the marketing mix (1) - Product

"Protect the consumer by owning the product all the way from the soil to the table."
- Henry John Heinz (1844 - 1919), Founder of Heinz Foods

Contents

4.5 The seven Ps of the marketing mix (1) - Product	
SL/HL content	**Depth of teaching**
Product The relationship between the product life cycle, product portfolio and the marketing mix	AO2
Extension strategies	AO3
The relationship between the product life cycle, investment, profit and cash flow	AO2
The following aspects of branding: (i) awareness, (ii) development, (iii) loyalty and (iv) value	AO2
The importance of branding	AO2

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CORE

Product in the marketing mix

The relationship between the product life cycle, product portfolio and the marketing mix. AO2

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A **product** is any good or service that serves to satisfy the needs or wants of customers. Products can be **tangible** (physical products such as computers) or **intangible** (services such as education). They can be sold to private individuals, to other businesses or to governments.

Each year, there are countless new products launched in both consumer and commercial markets. However, most new products fail to be a commercial success, but a special few may do well and go on to become a global success. Before customers part with their money, they consider whether the product offers value for money, i.e., whether the price justifies the potential benefits of consumption. Products must add value in order to stand any chance of success. Marketing has a large role in adding value to a product, perhaps through the use of product differentiation such as quality, packaging and/or branding (covered in the latter part of this chapter).

Products can be classified as consumer or producer goods. **Consumer products** are those purchased by private individuals

for their own personal use (see Box 27.1). **Producer products** are those purchased for commercial use, rather than for private consumption. They are used in the production process to help the running of a business, such as raw materials and components (used to make other products) and the purchase of noncurrent assets (see Chapter 15) such as land, machinery, tools and vehicles. In reality, many products (such as stationery, furniture and computers) cater for both private individuals and businesses. Their classification is only different based on who buys the product and for what purpose, rather than the physical attributes of the product.



Figure 27.1- Freshly baked bread products are perishable

Box 27.1 - Classification of products

- **Fast-moving consumer goods** (FMCGs) are every-day convenience products sold in retail outlets such as supermarkets, such as personal health care products, groceries, newspapers and confectionery. The profit margins on FMCGs tend to be low.
- **Consumer perishables** are products that do not last long, such as fresh flowers, unprocessed fruits and vegetables or raw seafood. They are different to FMCGs because purchases are not necessarily as frequent or stable and they can have high profit margins.
- **Consumer durables** are products that last for a relatively long time. They can take up a rather large proportion of consumers' incomes so are purchased irregularly, such as cars, furniture, sports equipment and electronic appliances.
- **Luxury products** are exclusive and highly expensive products that take up a significant proportion of the average consumer's income. Hence such purchases often require a large amount of commitment (money and time), such as designer jewellery, residential property and exclusive sports cars. Businesses can earn huge profit margins by charging premium prices for such prestigious products.

Theory of Knowledge (TOK)

Is it ethical business practice to significantly raise the price of fresh flowers on Mothers' Day and Valentine's Day? Are there any socially acceptable reasons for businesses exploiting the ability and willingness of consumers to pay high prices?

Theory of Knowledge (TOK)

What is beauty? Are businesses that promote beauty products ultimately acting unethically?

The product life cycle

The **product life cycle** shows the different stages that a product is likely to go through from its initial design and launch to its decline and eventual withdrawal from the market (in most cases). Its life cycle is measured over time in terms of sales revenue. The product life cycle (PLC) model allows managers to identify any necessary changes and to take appropriate action as part of an improved marketing strategy.

Some products have a relatively short life cycle whilst other products have prolonged life cycles. For example, Levi's (1837), Nokia (1865) and Colgate (1873) were established in the 19th Century. Moët & Chandon (a well-known brand of champagne) has existed since 1743 and Twinings Tea was founded in 1706. Some of the most popular high-tech companies were also established decades ago (see Box 27.2). By contrast, other products have a much shorter life cycle, such as IB textbooks, Hollywood movies, high fashion (clothing) products, pop music bands or smartphones. According to *Newsweek* magazine, mobile phones have a life cycle of about 18 months in the USA

before consumers replace their phones because newer and better-designed models are readily available on the market, even though the phones are made to last for more than 5 years.

Box 27.2 - Ten e-commerce brands with longevity

1. WhatApp (2010)
2. Twitter (2006)
3. YouTube (2005)
4. Facebook (2004)
5. LinkedIn (2003)
6. Wikipedia (2001)
7. Google (1998)
8. Netflix (1997)
9. eBay (1995)
10. Amazon (1994)

For most products, there are generally five stages to their life cycle: (i) research and development, (ii) launch (introduction), (iii) growth, (iv) maturity and (v) decline, as shown in Figure 27.2. Each stage is likely to have a different marketing mix and affect cash flows and profits in different ways.

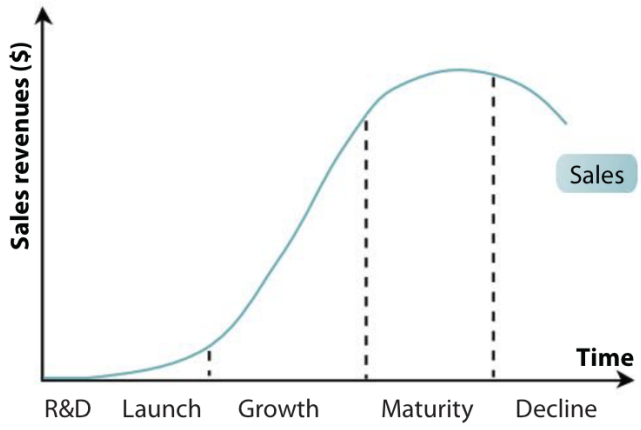

Figure 27.2 - The product life cycle

(i) Research and development (R&D)

The research and development stage involves the R&D department of an organization developing the ideas for a new product as well as the marketing department conducting thorough market research. Activities include idea generation, screening (deciding which ideas to develop further and which ones to drop), market research, market analyses, product development, testing of prototypes and test marketing. Test marketing enables final products to be tested with a focus group (representative of the target market) in a small geographical area in order to gather meaningful consumer feedback and adjustments to be made prior to the full launch of the product.

(ii) Launch (introduction)

At this stage, the product is introduced to the market. It is likely that a significant amount of promotion is required (see Chapter 29) in order to raise awareness and to encourage sales. This can be achieved through a combination of persuasive and informative advertising so that potential customers are aware of the product's benefits. The price may be high if the product has first-mover advantage (the first product of its kind in the market) or a unique sign point (such as new technologies and functionality). For firms entering existing markets, the product launch may require penetration pricing (see Chapter 28) in order to gain market share from current competitors in the market.

(iii) Growth

During this stage of the product life cycle, the product enjoys sales growth and brand recognition. Promotional techniques may include the use of persuasive advertising so that customers understand why the product is better than its competitors. This can help to establish brand loyalty. Marketing activities are focused on gaining higher market share, such as broadening distribution channels (see Chapter 30).

(iv) Maturity

At this stage in the product life cycle, the rate of growth in sales slows down, although the firm has significant market share. The combination of high sales and low unit costs (due to economies of scale due to the firm's growth) leads to higher profits which can be used to support the development of other products in the firm's portfolio. Advertising and other promotional activities focus on reminding customers about the product and its benefits. Due to the competition that exists in the market, the pricing of the product is likely to change. For example, the business might choose to use competitive pricing (see Chapter 28) in order to maintain market share.

(v) Decline

At the final stage in a product's life cycle, sale revenues and profits fall. Cost cutting become inevitable as there is no longer the need to use as many humans and financial resources to support the product. Promotion and advertising are likely to be cut or even eliminated at some point. Extension strategies may need to be used to prolong the product's life cycle (see next section below). If these methods do not work, the product is eventually withdrawn from the market., The business will need additional products in its portfolio to be launched in order to generate sales and profits for its survival.

Theory of Knowledge (TOK)

When does the life of a product actually begin? What determines what marketers consider to be the first stage of the product life cycle: launch or R&D (research and development)?

Product portfolio

CORE

A **product portfolio** refers to the collection of all the products owned by a business at a point in time. Product portfolio management enables a firm to have better control over its sales revenues, costs, profits and operational risks.

The **Boston Consulting Group matrix** (see Business Management Toolkit 4, Chapter 47) is the most popular marketing planning tool that helps managers to plan for a balanced product portfolio. For example, Apple's product portfolio includes the iPhone (smartphone), iPad (tablet computers), MacBook (laptops), Apple Watch (smartwatches), Apple TV (digital media and streaming services) and Apple Music (including hardware accessories such as AirPods, HomePods and Beats headphones).

Marketing

The Boston Matrix looks at products from two perspectives: market share and market growth. This allows marketers and managers to assess new and existing products in terms of their market potential. Product portfolio management allows a business to decide which products need more (or less) financial support and investment. Products that do not have high market share may be withdrawn or remarketed, for example. Product portfolio management also allows a business to develop appropriate growth strategies (see Chapter 5) by adding new products to an existing or new product range.

The Boston Consulting Group matrix shows that there are four categories of products in a firm's product portfolio:

- **Dogs** are products with low market share operating in a low growth market. These products do not generate much cash for the business because the market is stagnant or in decline, so businesses may need to use extension strategies or withdraw such products from the market.

- **Question marks** are products that operate in a high market growth sector but have low market share. These products need additional marketing funding to increase market share. Question marks are the main consumers of cash, so it is not always clear just how much a business should or can afford to invest in these products.

- **Stars** are products that operate in high growth markets and have high market share. They generate high amounts of cash for a business. Hence, marketing activities aim to develop and promote stars. The cash generated from stars can be used to turn some of the question marks into stars.

- **Cash cows** are products with high market share operating in a low-growth (mature) market. Such products are very well established, thereby generating large amounts of cash and of profits. However, some cash cows run the risk of becoming dogs, so businesses may need to use extension strategies to prolong their high earning potential.

The BCG matrix shows that the ideal product portfolio for a business is to have a balanced portfolio, which might include some stars, a few question marks and several cash cows. It is important to note that product portfolio management is not a static tool. The money generated from cash cows is used to turn stars into more cash cows and to provide funding for question marks. Appropriate marketing strategies need to be devised to support these changes. Managers also need to decide whether to spend money on reviving demand for dogs (through the use of extension strategies) or to withdraw all investments in them, thereby releasing cash for other products. Therefore, it is important that a business has a balanced range of products in its portfolio and markets these in appropriate ways. The relationship between a product's life cycle and the firm's product portfolio is illustrated in Figure 27.3.

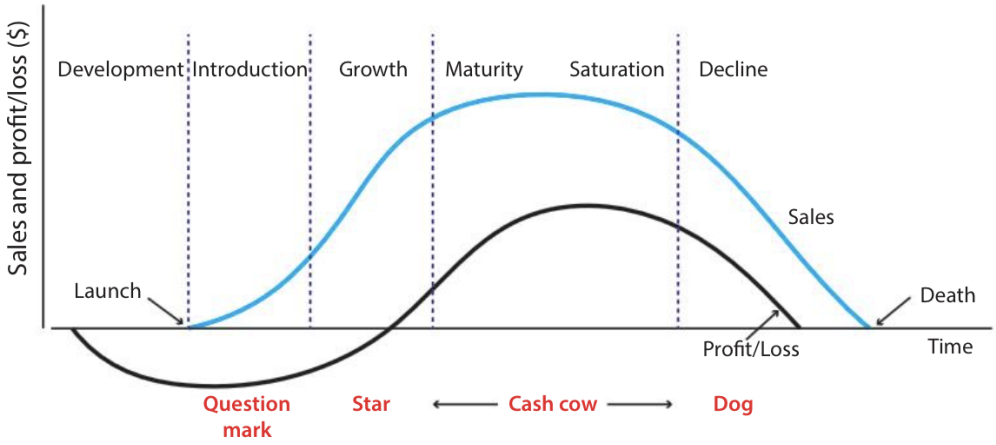

Figure 27.3 - The relationship between the product life cycle and a firm's product portfolio

Question 27.1 - The Virgin Group

The Virgin Group was set up in the early 1970s by British **entrepreneur** Sir Richard Branson. His entrepreneurial skills have led the Virgin Group to grow beyond a portfolio of over 200 companies. The core areas of the business are travel, entertainment and lifestyle. Its **product portfolio** includes the likes of Virgin Atlantic, Virgin Balloon Flights, Virgin Books, Virgin Galactic, Virgin Holidays, Virgin Hotels, Virgin Media O2, Virgin Megastores, Virgin Mobile, Virgin Money and Virgin Radio.

(a) Define the term *entrepreneur*. *[2 marks]*

(b) Define the term *product portfolio*. *[2 marks]*

(c) Examine the reasons why the Virgin Group needs a different marketing mix for each of its distinct products and services. *[6 marks]*

CORE

ATL Activity 27.1 (Research skills)

Discuss how **change** has influenced the product life cycle for an organization or brand of your choice.

Business Management Toolkit

Discuss how application of the Boston Consulting Group matrix (see Chapter 47) can help marketing managers to gain a better understanding of the relationship between the product life cycle, the firm's product portfolio and the elements of the marketing mix.

Extension strategies (AO3)

For products that reach saturation in their life cycle, prior to their decline, various extension strategies can be implemented to prolong their sales revenue. **Extension strategies** are any means of prolonging a product's life cycle and delaying a decline in its sales revenue. To do this, businesses need to find ways to keep customers interested in the product for longer in order to maintain or increase sales.

Apple's highly successfully iPhone was launched in 2007. To prolong the iPhone's life cycle, Apple introduced a range of options, including accessories and variations of the original product (such as different colours and size, as well as product specifications). These strategies helped the company to sell in excess of 2 billion iPhones in its first twenty years. The effects

of extension strategies on a product's sales and life cycle are illustrated in Figure 27.4.

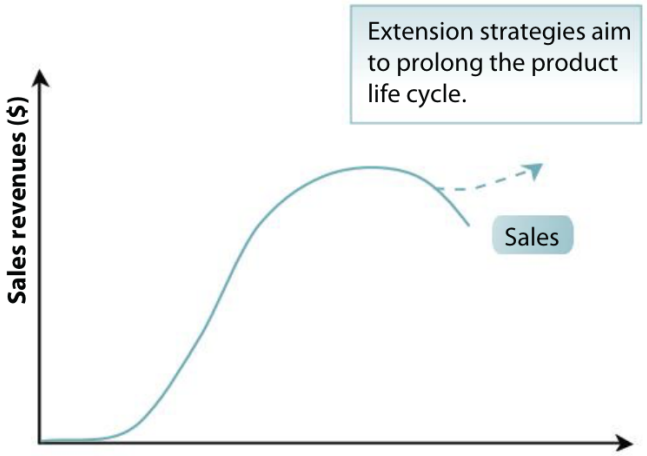

Figure 27.4 - Extension strategies

Common interrelated extension strategies include the following:

- **Price reductions** - Such strategies tend to increase the demand for a product, especially if it is price elastic in demand due to the wide availability of substitutes (see Chapter 28). Businesses also use price cuts to get rid of excess stocks before they become obsolete.

- **Advertising** - Additional and new promotional campaigns, such as advertising and sales promotions, can help to attract new customers, remind previous customers that the product still exists and persuade or encourage existing customers to purchse more of the product.

- **Redesigning** - This extension strategy involves introducing special features or 'limited editions' to a current product. In theory, this entices more customers to purchase the product as there has been additional value added in the production process.

- **Repackaging** - This involves changing the packaging of a product to help revive demand, perhaps by using more attractive colours or materials. The appearance of a product, including its packaging, can have a profound impact on demand (see Chapter 29). Presentation plays an important part in the marketing of most products, such as adding value to the product.

- **New markets** - Entering a new market for a current product can also extend its life cycle, such as trying to sell the existing product in new retail outlets, in different regions or even in overseas markets. For example, Ferrari not only produces exotic sports cars but has reinforced its brand by building its own theme park, Ferrari World Abu Dhabi, in the United Arab Emirates.

- **Brand extension** - This refers to the use of an existing and successful brand name to launch a modified or new version of the existing product, thereby prolonging its life cycle. For example, Coca-Cola is best known for its original Coke drink, but the company has successfully used brand extension strategies to launch a whole new line of products under the Coca Cola family brand, such as Diet Coke, Coke Zero and Cherry Coke.

- **Product differentiation** - These strategies can also help to prolong a product's life cycle. This refers to any marketing strategy that involves making a product stand out from others offered by rival businesses. Having a unique or distinctive element to the products offered by a firm can help the business to withstand competition. Successful product differentiation requires marketing support such as sales promotion as well as sufficient funding.

- **Change brand name** - This extension strategy is used if a product has suffered from negative publicity and falling sales. Changing the name of the brand product is a relatively straightforward way, in theory, to have a fresh start with the product remaining in its current format or slightly tweaked. For example, in late 2021, Facebook changed its name to Meta, with the company claiming that this was in line with its move to go beyond social media ('Meta' is Greek for 'beyond'). However, this also coincided with the timing of bad publicity for Facebook (accusations of violating antitrust laws), so the strategy could have been used as a way to distance itself from this.

- **Reposition the product** - This extension strategy involves the business exploring new markets for the product. It might be possible to revive the demand for a product by creating a new use for it or by adding value so that it appeals to a different target market. For example, Listerine was originally sold as a surgical antiseptic and later as a floor cleaner, before eventually becoming the mouthwash product that we know it for today. Similarly, Bubble Wrap was originally marketed as textured wallpaper in 1957 and later as greenhouse insulation, before being used for the purpose of keeping products safe during transit.



Figure 27.5 - Bubble Wrap was originally marketed as textured wallpaper

Business Management Toolkit

With reference to the Ansoff matrix (see Chapter 45), discuss how various growth strategies can extend the life cycle for a product of your choice.

The PLC, investment, profit and cash flow (AO2)

The relationship between the product life cycle, investment, profit and cash flow. AO2

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The phase of a product in its life cycle (see Figure 27.2) will have a direct impact on the firm's investment, profit and cash flow. These relationships are explained in the section below.

(i) Research and Development (R&D)

The R&D stage of a product's life cycle involves designing and testing the product. For most products, this is a time-consuming phase. A **prototype** (trial product) is often produced along with detailed market research (see Chapter 24) to assess the potential success of the product. **Test marketing** will usually take place. This involves trialling a new product with a sample of customers, perhaps in a limited geographical area, to determine the reactions of customers and to gather valuable feedback.

David Ogilvy (1911 - 1999), advertising guru and founder of Ogilvy & Mather, suggested that the most important aspect of R&D is testing. He argued that if a business pre-test its product with consumers and pre-tests its advertising, then it will have a much higher chance of success. This helps to minimise costs (and embarrassment) if the product is unsuccessful. If the product is unsuccessful at this stage, the business can either make changes based on the feedback of customers or discontinue the product altogether. However, test marketing can be expensive and competitors might find out about the product before its launch.

Studies have shown that most ideas at this stage do not proceed to the commercial launch stage, i.e., there is a high failure rate. Products that are commercialised must be priced competitively yet high enough to recover the R&D costs of both the successfully launched product and all those products that failed.

(ii) Launch (introduction)

The launch stage of the PLC requires careful marketing planning. Sales will be relatively low as customers are not fully aware of the product's existence. However, costs are very high due to the expenses involved in the launch phase, such as the costs of publicity, promotion and distribution. Hence, the product is unprofitable at this stage of its PLC and the business may face cash flow issues.

Therefore, it is important that marketing managers get the product to the next stage in the PLC as soon as possible. This will be easier to achieve for some products (such as blockbuster Hollywood movies) but more challenging for other products (such as new novels written by first-time authors). Customers who tend to buy products during the launch stage are referred to as **innovators**, i.e., those who like to be the first to own a certain product, perhaps due to prestige or because they are fanatics of the product, brand or company. For example, innovators have been observed queuing several days before the launch of Star Wars movies, Harry Potter books, Apple smartphones and Sony games consoles in order to be one of the first customers to purchase these products.

(iii) Growth

This stage of a product's life cycle sees sales revenue increasing. Growth is partly due to the business using wider channels of distribution to get the product to different customers in numerous locations (see Chapter 30). Brand awareness and the influx of customers at this stage of the PLC, known as the **early adopters**, also help to boost sales and cash flow.

Profits may materialise at this stage due to sales revenue rising and the possibility of lower unit costs from economies of scale in production (see Chapter 5). Businesses strive to prolong this stage as far as possible. However, profits will attract competitors to the industry. Hence, to remain competitive, the marketing

mix of the business may need to be reviewed and amended as appropriate.



Figure 27.6 - Apple has a loyal customer base of early adopters

(iv) Maturity

During the maturity stage of a product's life cycle, sales revenues continue to rise but at a much slower rate. The business may have obtained significant market share as sales revenues are at their peak. Cash flow and profits will be favourable due to the vast number of customers (called the **early majority**). Economies of scale will give the organization a competitive advantage, although there are likely to be many rivals in the market at this stage.

Saturation occurs when there are too many competitors in the market and sales revenues have peaked or have started to fall. The marketing mix will therefore focus on promotional activities to remind customers, rather than to persuade them, in an attempt to emphasise brand loyalty and encourage repeat purchases. Customers at this stage of the product life cycle are called the **late majority**). Marketing managers might also look to exploit new market segments for the product. Coca-Cola, founded in 1886, is an example of a product at its maturity stage - but it has been there for a very long time now!

(v) Decline

Decline is the final stage of the PLC (before its withdrawal or 'death' happens). During decline, sales and profit of the product fall and cash flow is less favourable. This could be due to lower customer demand, caused by changing fashion and tastes as well as new replacement models being available on the market, thus making the existing product obsolete. Customers at this last stage of the product life cycle are called **laggards**.

Investment for the product, including promotional expenditure, is cut and the price plummets. In reality, new products are likely to be launched before the previous product enters decline as this helps a business to maintain its cash flow and profitability as well as its relevance to customers.

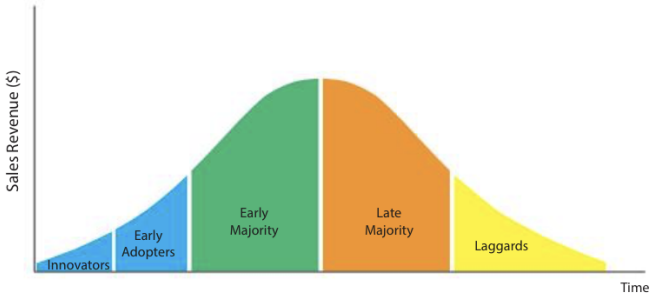

Figure 27.7 - Customers and the product life cycle

The life cycle of a product will therefore have varying effects on an organization's level of investment, profits and cash flow (as summarised in Table 27.1).

Table 27.1 - The PLC and its relationship with investment, profit and cash flow

PLC stage	Investment level	Profit	Cash Flow
R&D	Very high (research and development costs)	None	Highly negative
Launch	Very high (marketing)	Little, if any	Negative
Growth	High (persuasive promotions)	Yes, rising	Positive
Maturity	Low (mainly reminder promotions)	High, but little or no growth	Highly positive
Decline	Little, if any (extension strategies)	Yes, but falling	Positive, but falling

Question 27.2 - Sony PlayStation 5

Sony launched its ninth-generation games console, the PlayStation 5, in November 2020, seven years after its predecessor the PS4 was launched. It was quick to win positive reviews. The PS5 offers online connectivity with 4K resolution, high-speed data streaming, 3D audio effects, an optical disc drive that is fully compatible with Ultra HD Blu-ray discs and an 825GB solid-state drive. However, many existing customers became rather annoyed that the PS5 is backward compatible with most but not all existing PS4 controllers and accessories for PS4 games only and some with limited functionality.

The first-generation PlayStation was released in December 1994, whereas Microsoft did not launch its first Xbox until November 2001. Sony's **first mover advantage** in the games console market has led to its continued high degree of brand loyalty. During its **product life cycle**, the highly popular PS4 games consoles had sales of 116 million units worldwide

(a) Define the term *first mover advantage*. *[2 marks]*

(b) Define the term *product life cycle*. *[2 marks]*

(c) In the context of the case study, examine the relationship between a product's cash flow position and its life cycle. *[6 marks]*

Aspects of branding (AO2)

The following aspects of branding: (i) awareness, (ii) development, (iii) loyalty and (iv) value. AO2

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A **brand** refers to a name that is identifiable with a product of a particular business, although the term can also refer to a sign, symbol, colour scheme, font or design that belongs to the business. Interbrand, the internationally renowned branding consultants, defines a brand as "*A mixture of tangible and intangible attributes symbolised in a trademark.*" A **trademark** gives legal protection to the owner to have exclusive use of the brand name. For example, Microsoft's trademarked brands include Windows, Outlook, Bing, Edge, Skype, MSN, Surface, Word, Excel and PowerPoint.

There are four aspects of branding specified in the IB syllabus: (i) awareness, (ii) development, (iii) loyalty and (iv) value.

(i) Brand awareness

Brand awareness measures the extent to which people recognize a particular brand. It is often expressed as a percentage of the sample surveyed, e.g., 98% of respondents might recognize the Coca-Cola brand. Creating brand awareness is a key part of promoting a product or business. For example, in the bottled mineral water industry, there is very little to separate between the many suppliers in terms of taste. However, there is high brand awareness of Evian, Perrier, Dasani and Aquafina.

Case study 27.1 - Nike

'Nike' was chosen by Phil Knight, the company's founder and Chairman, because Nike was the Greek Goddess of Victory. It is also a short name, so is easier to spell and remember. Good brand names can stimulate positive associations with the product or business.

Theory of Knowledge (TOK)

Did you know *Evian* spelt backwards is 'Naïve'? Did you know that Dasani is produced by Coca-Cola and that Aquafina is made by Pepsi Co.?

Perrier claims that there are 50 million bubbles in its bottled water. Does it matter that such a knowledge claim is made or should this statement be proved as 'fact'?

Brand awareness plays a major part in the buying decision of consumers. For example, the Apple and Samsung brands have huge brand awareness and are often the first brands that people associate with smartphones and tablet computers. In general, the higher the level of brand awareness, the higher sales revenues will be. In addition, brand awareness gives the business a competitive edge over its rivals, resulting in greater market share. It can also encourage repeat purchases if customers like and trust the brand. Raising brand awareness is of particular importance during the launch stage of a product's life cycle.

(ii) Brand development

Brand awareness is a prerequisite to **brand development**, which refers to the ongoing and long-term marketing process of improving and enlarging the brand name in order to boost sales revenue and market share. Both brand awareness and brand development help a business to stand out from other brands in the market. Whilst brand awareness can occur quite quickly, especially with an effective marketing strategy, it takes a lot longer to develop a brand and the desired image.

Successful brand development helps to extend a product's life cycle. For example, Coca-Cola and Johnson & Johnson products were first launched in 1886, but remain highly successful brands today. However, the costs of brand development can be extremely high.

Nevertheless, brand owners generally strive to maximise the popularity of their trademarks. Some brands have become so famous (or 'genericised') that they are often mistaken for the name of the product itself (see Table 27.2). Such brands are known as genericised brands. There is a danger, however, that the generic use of a brand name leads to problems of enforcing copyright protection of the trademark.

(iii) Brand loyalty

Brand loyalty occurs when customers buy the same brand of a product repeatedly over time. Customers are devoted to the brand as they have brand preference over other rival brands. Brand loyalty is important to businesses for several reasons:

- It helps businesses to maintain or improve their market share.
- It enables businesses to charge premium prices for its products (see Chapter 28), which improves their profit margins.
- It acts as a barrier to entry in highly competitive markets, such as the fashion (clothing) and consumer electronics industries. This is because brand loyalty reduces the likelihood of brand switching.
- It plays a major role in the future success of a business, helping to prolong the product and brand's life cycles.

Table 27.2 - Brand or product?

Brand name	Product	Brand owner
Aspirin	Acetylsalicylic acid (drug)	Bayer AG, Germany
Astro Turf	Artificial lawn (or grass)	Textiles Management Associates
Band-Aid	Adhesive bandage	Johnson & Johnson
Biro	Ballpoint pen	Invented by Laszlo Biro in 1938
Blu-Tack	Reusable putty adhesive	Bostik Findley, Australia
Bubble Wrap	Air cellular cushioning material	Sealed Air Corporation, USA
Coke	Cola	Coca-Cola
Frisbee	Flying disc	Wham-O, USA
Hoover	Vacuum cleaner	The Hoover Company,
Hula hoop	Toy hoop	Wham-O, USA
iPod	Portable media player	Apple Inc., USA
Jacuzzi	Whirlpool bathtub	Jacuzzi, USA
Kleenex	Tissue paper	Kimberley-Clark, USA
Rollerblade	Inline skates	Tecnica Group, Italy
Tipp-Ex	Correction fluid	BIC Corporation, France
Wyteboard Marker	Board marker pen	Pilot, Japan

Question 27.3 - French Connection, UK



British clothes retailer French Connection sells its clothing products and accessories throughout the world. The company became well known for its 'FCUK' initialism (French Connection, UK) used in its advertising campaigns throughout the 2000s causing widespread controversy over its use of shock marketing techniques. A number of their advertisements were banned in the UK and USA.

By the early 2010s, customers, it seemed, were growing tired of the FCUK brand which lost its **brand loyalty** and shock factor over time. In response to losing market share to rivals such as Zara, French Connection stopped using the initialism in its advertising and revamped its pricing strategies.

(a) Define the term *brand loyalty*. *[2 marks]*

(b) Explain why brand loyalty is important to a business such as French Connection. *[4 marks]*

The opposite of brand loyalty is **brand switching**, i.e., consumers turn to alternative brands mainly because the original brand has lost some of its former appeal. For example, customers might switch to rival brands that are more competitively priced or because the competing product might offer better functions and services. To prevent brand switching, businesses often use **customer loyalty schemes** (see Chapter 43). These are a form of sales promotion used to entice customers to stick to the brand by rewarding devoted customers. An example is the Air Miles loyalty scheme used by many airline companies.

(iv) Brand value

Brand value refers to the premium that customers are willing to pay for a brand name over and above the value of the product itself. This means that customers are willing to pay more for a reputable brand, such as a Starbucks coffee, than for the product itself, such as coffee from a low-cost fast-food restaurant or convenience store. This is because consumers believe that a well-known brand offers better value for money than products that are less well-known. Brand awareness, brand development and brand loyalty all have a role in improving an organization's brand value.

There are numerous advantages for businesses that try to boost their brand value:

- **Higher market share** - Market share is an indicator of the level of brand development and brand loyalty. There is a strong and positive relationship between a firm's market share and its level of brand value. Marketers try to improve this by spending on brand development, including the use of persuasive promotional campaigns.
- **Premium prices** - Having high brand value allows a business to charge higher prices for its products because customers feel that they are paying for the value added that the brand carries, such as the reputation or prestige of the brand. This gives customers reassurance that the product is genuine, reliable and of good quality. Market leaders are also able to set their own prices whereas rivals could be forced into charging prices determined by the brand leader.



Figure 27.8 - Brand value enables businesses to charge premium prices

- **Higher barriers to entry** - Brand value makes it more difficult for new businesses to enter the market and compete, simply because customers are loyal to the existing brand. The dominance of brands such as Adidas, Coca-Cola, McDonald's and Rolex have created huge obstacles for rival brands. Products with high brand value can then enjoy the status of being cash cows for the business (see Chapter 47).

Question 27.4 - The top brands in the world

Interbrand, the world's largest branding consultancy firm, conducts annual rankings of the world's top brands. These brands must have a global presence with at least 20% of sales coming from outside their home country. Interbrand assesses each brand based on its future earning potential. Some of the most valuable global brands include Amazon, Apple, Coca-Cola, GE, Google, IBM, IKEA, Intel, Louis Vuitton, McDonald's, Mercedes-Benz, Microsoft, Samsung, Tesla and Toyota.

Source: adapted from www.interbrand.com

(a) Explain why globally recognised brands such as Coca-Cola, IKEA and Toyota continue to spend huge amounts of money on brand development. *[4 marks]*

(b) Examine how the brand name might determine the future success of a business. *[6 marks]*

Packaging also has a profound impact on customer perceptions of brand value. For example, imagine buying jewellery from Tiffany & Co., a handbag from Chanel or perfume from Christian Dior and receiving the products in a bland plastic carrier bag! Customers perceive quality packaging with a quality brand.

CORE

Business Management Toolkit

Discuss the elements of the marketing mix including branding and product differentiation in relation to Porter's generic strategies (see Chapter 53).

Branding strategy is used to reinforce the four aspects of branding. This often includes the use of slogans and logos to emphasise the brand and what it stands for. Slogans are memorable catchphrases used to gain and retain the attention of customers. A slogan is a concise message designed to represent the essence of a business or its products in a memorable set of words.

Skeptics argue that customers are not so easily fooled by the use of a few words that promise to deliver. The product itself, they argue, is of more importance to make businesses stand out from their rivals. However, some slogans have become so well known that they are synonymous with the brand. Heinz, for example, launched its 'Beanz Meanz Heinz' slogan in 1967 and although it was dropped for ten years, the slogan was relaunched due to public demand. Box 27.3 shows other examples of highly successful corporate slogans.

Box 27.3 - Ten popular business slogans

- *Impossible is nothing* - Adidas
- *Don't leave home without it* - American Express
- *The ultimate driving machine* - BMW
- *It's finger lickin good* - KFC
- *Because you're worth it* - L'Oreal
- *I'm Lovin' It* - McDonald's
- *Just do it* - Nike
- *Gives you wings* - Red Bull
- *Eat Fresh* - Subway
- *Save Money. Live Better* - Walmart

Theory of Knowledge (TOK)

Are knowledge claims actually being made when businesses use slogans such as "*Taste the rainbow*" (Skittles) and "*The Happiest Place on Earth* (Disneyland)? Does 'truth' matter in the use of business slogans?

Logos are essentially a form of branding that uses a visual symbol to represent a business, its brands or its products. The golden arches (the 'M') of McDonald's and the 'three stripes' of Adidas are two examples of globally recognized logos. Businesses can spend millions of dollars coming up with suitable logos which are distinctive, eye-catching and appealing. Logos can also create monetary value for businesses. For example, BMW bought the Rolls Royce 'RR' logo and brand for £40 million ($56.8m) in 1998. Many non-profit organizations, such as The International Red Cross and the World Wild Fund for Nature (WWF), also use logos as part of their promotional strategy.



Figure 27.9 - The WWF logo is widely recognised around the world

The importance of branding (AO2)

Branding is a form of differentiating an organization's products from those of its competitors. Research has shown that the world's most well-known brands can be so influential that they actually alter the consumer's feelings and/or their perceptions of the product. It is therefore essential that marketers and managers realise the importance of branding, which include:

- *Branding is a legal instrument* - Brand names create a **legal identity** for a product by giving it a unique and recognisable name and image to differentiate it from other products. For example, some businesses use branding to create an upmarket image for their products, such as Gucci, Versace, Rolex and Rolls-Royce. As a legal instrument, branding gives lawful ownership to the business and protects it from imitations.

- *Branding is a risk reducer* - Brands can give new products a better chance of survival. They can create a sense of value for money and encourage brand loyalty. There is plenty of research to show that customers remain devoted to the purchase of well-known brands. Brands also help to prolong the life cycle of a product. However, this also requires the business to invest money in marketing and sustaining customer loyalty to the brand.

- *Branding is an image enhancer* - Successful brands allow a business to charge a premium price (see Chapter 28) because customers are often willing to pay a substantially higher price for a 'good' brand. This also allows the business to earn higher profit margins. Lexus, the luxury division of Toyota, is able to charge premium prices due to the high-class image of its brand of cars. Psychologists and marketers have shown that purchasing decisions are not simply based on the price or functions of a product but also the 'feel good factor' associated with owning a particular brand.

- *Branding is a revenue earner* - Branding can encourage brand development (including extension strategies) and brand loyalty. This means that customers have a preference over other rival brands. Customers might also perceive the brand as superior to others so will not tend to buy substitute products. Thus, the demand for the firm's product is price inelastic (less sensitive to changes in prices). This enables the business to charge a proportionately higher price without losing customers, so it earns higher sales revenues despite charging higher prices (see Chapter 28). Brand loyalty also makes brand extension strategies much easier to accomplish.

Advocates of branding as a marketing strategy go as far as to argue that a brand is more important than the product itself, because they differ in several ways:

- *Intangibility* - Brands represent the intangible value that customers place on the actual physical product. Marketers argue that it is the brand that sells a product, not the other way round.

- *Uniqueness* - Brands are unique, whereas a product is quite easily copied.

- *Timeless* - Successful brands are timeless, whereas products can become obsolete (as they reach the end of their life cycle). Sony's Walkman personal stereos and first-generation PlayStation games consoles were withdrawn in the late 1990s, but both brand names live on.

Ultimately, these interlinked factors mean that branding is important to a business as it enables the firm to earn more profits. For example, the strength of sports club brands such as 'Manchester United', 'Real Madrid', 'Houston Rockets' and 'New York Yankees' has enabled such businesses to extend their merchandising in overseas markets, to provide financial services and to have their own digital TV channels. Businesses that use branding effectively gain from improved profitability. However, developing a brand is very expensive and can take many years. Most brands fail to ever become established in the marketplace, whilst many existing brands need regular investment or must evolve to survive.

Box 27.4 - Famous brands named after their founder

- Ferdinand Porsche
- Michael Dell
- Coco Chanel
- Enzo Ferrari
- J.P. Morgan
- Will Keith Kellogg
- James L. Kraft
- Ferruccio Lamborghini
- Levi Strauss
- Louis Vuitton
- Ann Summers
- William Fox
- William Boeing
- William Colgate
- William Wrigley Jr
- Frank C. Mars
- Henry Ford
- Henri Nestlé
- Alfred Nobel
- Walt Disney

Box 27.5 - Behind the name of famous brands

- 7-Eleven - Founded in 1927, the opening times of 7-Eleven convenience stores were originally from 7am to 11pm.
- Adidas - The sports apparel giant got its name from the founder of the company, **Adi Das**sler.
- Duracell - The world's top selling AA and AAA sized battery brand takes its name by blending the words 'Durable Cell'.
- IKEA - The world's largest home furnishing business, established in 1943 by **I**ngvar **K**amprad, gets its name from the initials of the founder and **E**lmtaryd **A**gunnaryd, the farm and village where he grew up.
- Intel - The world's leading producer of microprocessors and semiconductors was founded in 1968 as **Int**egrated **El**ectronics Corporation.
- Mattel - The American toy manufacturer, with brands such as Fisher-Price, Tyco, Barbie, Matchbox and Hot Wheels, gets its name from the company's founders - Harold '**Mat**t' Matson and **El**liot Handler.

CORE

Marketing

Question 27.5 - Lexus



Toyota was founded in 1937 and is the largest automobile manufacturers in the world. Lexus is the luxury division of Toyota, having been launched in 1989. Its success has been incredible. Since 2000, Lexus has sold more luxury vehicles in the USA than any of its foreign and domestic rivals, such as Mercedes-Benz, Jaguar, Audi, BMW, Lincoln and Cadillac. Lexus has also secured significant market share in many countries, including Singapore, South Korea, Thailand and Brunei. Time after time, Lexus has been voted by drivers as the most reliable car brand on the planet. Today, the Lexus brand is sold in over 90 countries. It is Japan's bestselling brand of premium cars and is one of the country's largest global brands by market value.

(a) Explain why Toyota might have chosen to label its luxury cars as 'Lexus' rather than 'Toyota', a much more globally recognized brand at the time. *[4 marks]*

(b) Discuss the role and importance of branding to a multinational company such as Toyota. *[10 marks]*

Branding is also important on an international scale. It is integral to any international marketing strategy. Scientists, economists, psychologists and marketers have all produced evidence to show that branding can have a huge impact on the buying decisions made by consumers. It is very common that consumers make their purchasing decisions based on the perception of a brand rather than the qualities of the actual product. Hence, focused market research and planning are required to extend the success overseas. Matt Haig, author of *Brand Failures*, found that highly successful brands can lose their value overnight because customer perception of products and brands can be fragile. A successful branding strategy in one part of the world does not mean that the same formula will work in other places. Branding also becomes a more complicated issue when operating overseas

Product and the key concepts

Creativity has a huge role to play in the success of a product. Successful products provide customers with added value. *Functional value* refers to what the product actually does for the customer, e.g., Coca-Cola helps to quench people's thirst, whilst Apple's iPhone lets consumers listen to music, play games, watch movies and access the Internet - as well as make telephone calls! *Emotional value* refers to the psychology behind the purchase of a product, e.g., designs that suit personal styles and tastes or the feel-good factor of owning a particular brand or product. This means that product strategies, such as creative designs and branding, are vital in adding value to a product.

Sustainability is also important for successful products also foster brand loyalty, which helps a business to develop and launch new products under the same brand name (using brand extension strategies). Cadbury's, Virgin and Samsung are examples of successful businesses that have used their brand names to enlarge their product portfolios, thereby strengthening their competitive position in an ever-changing and competitive world.

Change provides both opportunities and threats for marketers, although product strategy becomes more difficult when operating on an international basis (see Chapter 34). Some products have become so popular on an international scale that they are called **global brands,** i.e. the same product is sold with exactly the same (or very similar) marketing strategies used in overseas markets. Examples of global brands include Apple, Chanel, Coca-Cola, Disney, HSBC, McDonald's, Microsoft and Nike. Their image, physical make-up and appearance are almost identical wherever they are marketed on the planet, i.e., there is consistency in the marketing of these products despite changing and varying circumstances. The key driving forces for global branding strategies are brand exposure and the cost savings gained from using a single international marketing approach.

Nevertheless, ethical and cultural considerations have led to a greater focus on the local needs of overseas customers. Thus, many global brands have been **glocalised** to cater for local preferences whilst retaining the core elements of the global brand. For example, the core food menu at McDonald's is almost the same throughout the world, but different products are also included to cater for local tastes and preferences.

In an ever-changing business world, the products of a business are vital to its success. Technology, fashion, tastes and trends are continually subject to change and it is the businesses that are able to adapt their product portfolios to changing market trends and needs that stand a chance to do well in the future.

CORE

Question 27.6 - The Coca-Cola Company

Coca-Cola is one of the biggest brands on the planet. The company, founded in 1886, claims that its brand name is the second most understood word in the English language (after 'OK'). Coca-Cola (also referred to by its trademark name 'Coke') is synonymous with American culture. The company preserves the position of its brand by devoting a huge amount of money (in the region of $2 billion each year) to its marketing. For example, Coca-Cola is one of the largest sponsors of sporting events, such as the NBA (basketball), the NHL (hockey), the Olympic Games and the FIFA World Cup (football).

(a) Explain why a brand name is of huge importance to a business such as Coca-Cola. *[4 marks]*

(b) Examine whether established organizations such as Coca-Cola should devote time and resources to brand development. *[6 marks]*

For example, Nokia started as a wood manufacturing business in 1865; Nintendo made playing cards back in 1889; Wrigley produced soap powder in 1891 before specialising in chewing gum; and Motorola initially produced car radios in 1928. The dynamic and changing nature of business activity means that complacency is potentially disastrous. Theodore Levitt (1960) pointed this out when he wrote about **marketing myopia**. This exists when businesses become complacent about their product strategy, thereby failing to keep up with market changes.



Figure 27.10 - Nintendo switched from making playing cards to video games

However, producing the 'right' product to the right people at the right price is challenging due to the costs and other complexities involved. Different products require different marketing strategies. Fiat Group, Italy's largest car manufacturer, does not market Fiat cars in the same way it does for its Alfa Romeo, Maserati and Ferrari marques (brands). For a business to remain competitive, it has to carefully plan its product strategy whilst managing a diverse portfolio of products. Many large companies, such as Fiat, have benefited from developing a **multi-brand strategy.** This involves a business developing two or more brands in the same product category. Another example is Coca-Cola, which uses brands such as Fanta and Sprite to gain a greater share of the soft drinks market. However, **product cannibalization** is a potential problem of a multi-brand strategy - when brands from the same business directly compete with each other.

Finally, it is important to point out that although 'product' is often said to be the most important part of the marketing mix, a product strategy cannot succeed without integrating the other elements of the marketing mix and marketing planning. For example, to fully understand and cater for different customer needs, market segmentation and consumer profiling (see Chapter 24) might be necessary. Understanding the other aspects of the marketing mix will help managers to devise and implement better product strategies in order to compete in a more sustainable way in an ever-changing business environment.

Business Management Toolkit

Discuss the extent to which cultural differences and regional preferences have a direct impact on the success of a brand or product. You might find it useful to refer to Chapters 11 and 54 prior to answering this question.

Key concept

Examine the role of **sustainability** and **creativity** for new product design (including product specifications) of the goods for an organization of your choice.

Theory of Knowledge (TOK)

Scientists and business analysts have shown that branding can be so remarkable that it affects the human brain. For example, the Coca-Cola brand stimulates parts of the human brain associated with cultural knowledge, memory and self-image.

How far do scientific knowledge claims go in our acquisition of knowledge in Business Management?

REVIEW QUESTIONS

1. What is a product?
2. How do tangible products differ from intangible products?
3. How do consumer products differ from producer products?
4. How do consumer durables, consumer perishable products and fast-moving consumer goods differ from each other?
5. What is the product life cycle?
6. What are the main stages in a typical product life cycle?
7. What is meant by product portfolio?
8. Why is it important for a business to have a balanced product portfolio?
9. What are extension strategies?
10. What is the relationship between the product life cycle, investment, profit and cash flow?
11. What is a brand?
12. What is brand awareness?
13. What is the difference between 'brand loyalty' and 'brand development'?
14. What is brand value?
15. Why is branding important for businesses?



Figure 27.11 - The Coca-Cola brand is recognized throughout the world

KEY TERMS

A **brand** refers to a name that is identifiable with a product of a particular business.

Brand awareness measures the extent to which people recognize a particular brand.

Brand development refers to the ongoing and long-term marketing process of improving and enlarging the brand name in order to boost sales revenue and market share.

Brand loyalty occurs when customers buy the same brand of a product repeatedly over time.

Brand switching occurs when consumers turn to alternative brands mainly because the original brand has lost some of its former appeal.

Brand value refers to the premium that customers are willing to pay for a brand name over and above the value of the product itself.

Branding refers to the practice of using an exclusive name, symbol or design to identify a specific product or organization.

Consumer goods are products bought for personal consumption, such as furniture, computers and fresh flowers.

Customer loyalty schemes are a form of sales promotion used to entice customers to stick to the brand by rewarding devoted customers.

Extension strategies are attempts by marketers to lengthen the life cycle of a particular product, typically used during the maturity or early decline stages of the product's life cycle.

Genericised brands are so popular that they become synonymous with the name of the product itself.

Global brands are highly popular products sold with exactly the same (or very similar) marketing strategies in overseas markets, using the same brand name in different countries.

Innovators are consumers who strive to be the first to own a certain product, usually due to prestige or loyalty to a particular brand or product.

Intangible products are non-physical services, such as haircuts bus rides and visits to the cinema.

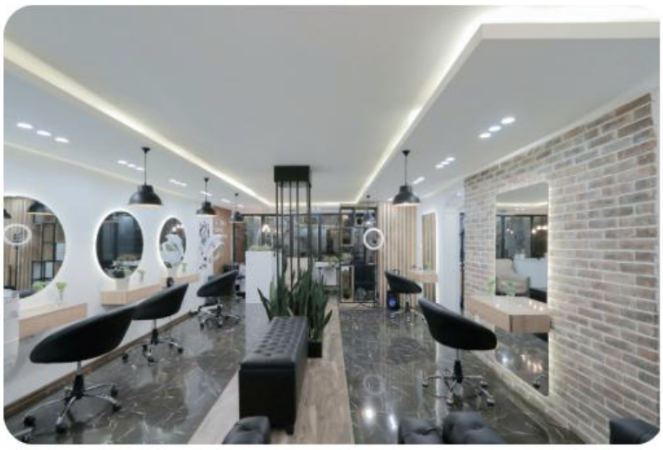

Figure 27.12 - Hair salons provide services as intangible products

Logos are a form of branding that uses a visual symbol to represent a business, its brands or its products.

Marketing myopia exists when a business becomes complacent about its product strategy, thereby failing to keep up with market changes.

A **multi-brand strategy** involves a business developing two or more brands in the same product category.

Producer goods are products purchased for commercial (business) use, rather than for private consumption.

Product refers to any physical or non-physical item (good or service) that is purchased by commercial or private customers.

Product cannibalization occurs when brands from the same business directly compete with each other.

Product differentiation refers to any strategy used to make a product appear to be distinct from others, such as quality, branding and packaging.

The **product life cycle** refers to the typical process that products go through from their initial design and launch to their eventual decline and withdrawal at varying speeds.

Product portfolio refers to the collection of products owned by an organization at any one point in time.

A **prototype** is a trial product, produced to assess the potential success of the product.

Slogans are catchphrases used to represent the essence of a business or its products in a memorable way.

Tangible products are physical goods, such as cars, computers and smartphones.

Test marketing is the trialling a new product with a sample of customers, perhaps in a limited geographical area, to determine the reactions of customers and to gather valuable feedback before a full launch.

A **trademark** gives legal protection to the owner to have exclusive use of the brand name.

Chapter 28

Unit 4.5 - The seven Ps of the marketing mix (2) - Price

"The higher the price you have to pay, the more you will cherish it"
- Lloyd C. Douglas (1877 - 1951), American minister and author

Contents

4.5 The seven Ps of the marketing mix (2) - Price	
SL/HL content	**Depth of teaching**
Price • The appropriateness of the following pricing methods: • cost-plus (mark-up) • penetration • loss leader • predatory • premium pricing • dynamic pricing (HL only) • competitive pricing (HL only) • contribution pricing (HL only) • price elasticity of demand (HL only)	AO3

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Price

The appropriateness of the following pricing methods: (i) cost-plus (mark-up), (ii) penetration, (iii) loss leader, (iv) predatory, (v) premium pricing, (vi) dynamic pricing (HL only), (vii) competitive pricing (HL only), (viii) contribution pricing (HL only) and (ix) price elasticity of demand (HL only). AO3

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Price refers to the amount paid by a customer to purchase a good or service. The pricing decision is a crucial part of any marketing strategy. Many products fail due to poor pricing decisions. The dilemma facing businesses is to set a price that is competitive yet also profitable as the pricing decision has a direct impact on the level of sales revenues. Setting too high a price deters customers, whilst setting too low a price could lead to a lack of stock (inventory) and hence dissatisfied customers.



Figure 28.1 - Price is a vital aspect of the marketing mix

Price can also directly affect the corporate image of a business or its products. Producers and suppliers of luxury brands, such as Omega or Gucci, might benefit from minimal price cuts in the short term but sustaining lower prices in the long term will damage their reputation, perhaps irrevocably. Hence, businesses need to have a clear understanding of the link between the price and the demand for their products.

There are nine pricing methods stated in the syllabus, five of which are applicable to both SL and HL students and an addition four pricing methods for HL only students.

(i) Cost-plus (mark-up) pricing

This pricing method involves adding a percentage or pre-determined amount of contribution to the cost per unit of output to determine the selling price. The percentage or specific amount is known as the **mark-up** (or **profit margin**). For example, if a coffee shop estimates the average cost of its coffee drink to be $2 and wants to have a 100% mark-up, the price is set at $4. Alternatively, if the business wanted to earn $1.50 profit on each cup of coffee sold, the average selling price would be $3.50.

The main advantage of cost-plus pricing is its simplicity and ease of calculation. However, cost-plus pricing often relies too much on intuitive decision making, rather than on any actual market research about the needs of customers.



Figure 28.2 - Mark-up pricing is commonly used in coffee shops

(ii) Penetration pricing

Penetration pricing is a pricing method that involves setting a low price in order to enter an industry. It allows the business to compete against existing firms in the industry and to gain market share.

Quite often, penetration pricing takes the form of a heavily advertised discounted price offer in order to attract a large number of customers in a short space of time. The low price can also allow the firm to create brand awareness and brand recognition. As the firm or its product gets established and gains brand recognition, the price can be raised. For example, China's Brilliance Auto launched its cars in Europe in 2007 at around 15% lower than the prices of rival car manufacturers such as South Korea's Hyundai.

CORE

Marketing

Question 28.1 - Tanusankar Trampolines Co.

The average cost of production for Tanusankar Trampolines Co.'s best-selling trampolines is $150. The company uses a **mark-up** of 125%.

(a) Define the term *mark-up.* *[2 marks]*

(b) Calculate the selling price of Tanusankar Trampolines Co.'s best-selling trampolines. *[2 marks]*

Tanusankar Trampolines Co. sells a cheaper trampoline for $205, for which the production costs are $95.

(c) Calculate the percentage profit margin (mark-up) on these cheaper trampolines. *[2 marks]*

This strategy is suitable for mass market products that sell in large enough volumes to sustain low profit margins, such as fast-moving consumer goods sold in supermarkets. It is also suitable for products that have a high price elasticity of demand (PED) whereby lowering price leads to proportionately higher sales volume.

(iii) Loss leader pricing

Loss leader pricing involves selling a good or service below its cost value. Retailers such as supermarkets often use this pricing method by heavily advertising the loss leader (such as toilet paper or carbonated soft drinks) in the hope of attracting customers. It is unlikely for customers to purchase only the loss leader products when visiting a supermarket, yet the existence of loss leaders can attract many more customers. Loss leader products can also be used to encourage brand switching, which in the long term can make up for the losses incurred whilst the product was priced at a loss.

Games console makers such as Sony, Nintendo and Microsoft often sell their hardware at a loss to attract buyers. The aim is to recoup the loss by the subsequent and ongoing sales of complementary goods such as games and accessories, as well as revenues from subscription services and earning royalty payments from games manufacturers. Manufacturers argue that if the consoles are too expensive, people simply wouldn't buy them or buy a cheaper alternative. If customers do not buy the console, nobody would buy the games made for it. Sony claim to break-even on their games console once a customer has bought two games.



Figure 28.3 - Manufacturers of games consoles use loss-leader pricing

Loss leader pricing is also commonly used when a business wants to enter or penetrate a market. It is used to attract new customers to a good or service with the intention of establishing a customer base and securing future and recurring sales revenues.

Case study 28.1

IHS, an American electronics and media research company, reported that the Sony PlayStation 4 costs $372 to build plus $9 for direct labour, bringing the total cost of each unit to $381. This is just $18 below the retail price of $399 at its launch in November 2013.

Theory of Knowledge (TOK)

To what extent can we truly know the actual value of a product just from the price?

(iv) Predatory pricing

Predatory pricing involves temporarily reducing price in an attempt to force competitors out of the industry as they cannot compete in a profitable way. The aggressive nature of this pricing method means that the price is set so low (in order to attract customers away from competitors) that it destroys the sales of rivals in the market that cannot compete on price.

Predatory pricing often stems from a **price war**, whereby businesses compete by a series of continuous and/or intensive price cuts. This might even mean selling products at below cost value. Price wars are common in the supermarket, airline and mobile phone industries. If the strategy is successful, the firm will benefit from being in a more dominant position in the market, so can therefore raise its prices to recoup any losses previously incurred. Although price wars can bring some benefits to customers in the short term, predatory pricing itself is illegal in many parts of the world (such as in the USA and EU) because it is regarded as an anti-competitive trade practice.

Question 28.2 - The price of price wars



The world's largest supermarket chains (such as Walmart, Carrefour and Tesco) have huge market power to reduce prices. Price reductions, including the use of **loss leader pricing**, are a key technique used by supermarkets to improve their competitiveness. For example, British consumers have grown accustomed to supermarket **price wars**, with over £1 billion ($1.4 bn) of price reductions each year.

(a) (i) Define the term *loss leader pricing.* *[2 marks]*

(ii) Define the term *price wars.* *[2 marks]*

(b) Examine the winners and losers of a price war in the short term and the long term. *[6 marks]*

(c) Recommend **two** forms of non-price competition that supermarkets might use to increase their competitiveness. *[10 marks]*

(v) Premium pricing

Premium pricing is when the price of a good or service is set significantly higher than similar competing products, usually because the product is of higher quality or is sufficiently unique enough to justify the premium price. For example, Nike and Adidas use premium pricing (their products are generally more expensive than those from similar competitors in the sports apparel market). Customers perceive owning premium priced products as a symbol of success, wealth, status or prestige.

Another example is Honda's NSX supercar with a starting price of $420,000. Whilst a Honda Jazz, which starts at a price of $15,990, might be just as reliable and serve the same or similar purpose, customers of the NSX perceive the car being of higher quality and of much more than a status symbol than a Jazz. For customers of such premium products, the price itself is not the main concern or factor in the purchasing decision.



Figure 28.4 - The Honda (Acura) NSX

The demand for premium priced products tends to be price inelastic (see below). This is because of the unique selling point over other rival products and/or the lack of suitable substitutes. For example, popcorn, hot dogs and soft drinks are sold at a high (premium) price at movie theatres.

Premium pricing has the advantage of generating higher profit margins for the business. It can also create higher barriers to entry for competitors if it can establish a loyal customer base. Businesses that use this pricing method, such as Nike and Gucci can also gain from increasing the brand's value for all their products.

A drawback of premium pricing is that it can limit the number of customers, due to the relatively high price. Furthermore, premium brands may lose their status if they appeal to the mass market. In addition, premium pricing requires strong brand loyalty, which can be expensive to establish and maintain. Ultimately, customers must be convinced that the product is worth the premium price.

Exam tip !

Classifying pricing strategies is not necessarily straightforward. A business selling a product at $9.95 might be perceived to be using psychological pricing, but this could equally be any other pricing strategy, such as mark-up, penetration, loss leader or predatory pricing. For other products, it might even be a premium price.



What pricing strategy is this (USD191.4 for a bunch of Japanese Shine Muscat grapes)?!

(vi) Dynamic pricing (HL only)

Dynamic pricing is the practice of varying the price of a good or service to reflect changing market demand, often with price changes throughout the day. In particular, businesses charge higher prices during peak periods (times of greater demand) and lower prices during off-peak periods (when demand for the product falls). Unlike the other pricing methods above, dynamic pricing is flexible and adaptive so that businesses are able to update their prices to capitalize on ever-changing market conditions, including offering price discounts when market demand is low and when the business has plenty of spare capacity.

Fundamentally, dynamic pricing (sometimes referred to as **real-time pricing** or **surge pricing**) is about selling the same product at different prices based on the changing dynamics of the market for a particular product. For example, before setting prices, a business might need to determine several interrelated factors such as the time of day, day of the week, level of consumer demand, the location of the customer and the prices charged by competitors.

The following are examples of businesses and industries that use dynamic pricing. In all cases, the use of surge pricing enables the business to generate higher levels of sales revenue.

- Airline operators charge passengers more during peak periods but less if customers book their tickets in advance.
- Cinemas often charge higher prices for peak showings, such as during the first weekend release of a major blockbuster movie.
- Hotels and accommodation providers such as Airbnb base their prices on the time of year. Prices account for different seasonal holidays and other special days in the year.
- Taxi operators and ride-sharing services such as Uber and Lyft often charge more during peak hours and adverse weather conditions (such as rain, snow, fog and storms).



Figure 28.5 - Taxi companies often use dynamic pricing

Advantages of dynamic pricing include giving businesses greater control over their pricing method, with real-time data enabling firms to set the right (optimal) prices for different products. This will also enable the firm to maximize its profits.

A major disadvantage of dynamic pricing is that customers are often unhappy about not knowing just how high a price they have to pay for the good or service. They often feel exploited (being overcharged). This can damage the reputation of the business and/or harm future sales. For businesses, dynamic pricing can lead to price wars as firms try to undercut each other during off-peak periods to attract more customers. Price wars are not sustainable in the long-term and can even lead to bankruptcies.

HIGHER LEVEL

Question 28.3 - The price of strawberries

Using the method of dynamic pricing, explain why fresh strawberries are more expensive during the winter season. *[4 marks]*



Theory of Knowledge (TOK)

To what extent is dynamic pricing unethical and inequitable?

CORE

(vii) Competitive pricing (HL only)

Competitive pricing is the practice of a business setting the price of its goods or services at the same or similar level to that of its competitors. It is also referred to as **going-rate pricing** as it involves setting a price that is in line with the prices charged by rival firms. It is suitable in industries where a product has been on the market for a while and there are many substitutes widely available. For example, the Apple iPhone is priced at a similar level to the Galaxy S Series range of smartphones.

Essentially, there are three options for the use of competitive pricing:

1. Pricing above the competition – This method could be suitable for a business that believes setting a higher price can help its brand image of being a superior product. However, in order to charge more, the business might need to provide extra features or services to justify the slightly higher price.

2. Pricing on the same level as the competition – When a business does this, the focus of competitive advantage is not price but brand differentiation, such as the special features of the product.

3. Pricing below the competition – this method could be suitable for businesses trying to survive in a highly competitive market. However, setting a lower price means lower profit margins, as well as potentially negatively affecting the brand's image.

In a highly competitive world, where price is an important factor in purchasing decisions, businesses have to keep an eye on their competitors. In competitive markets, customers will be offered a wide choice of products from rival suppliers. Customers will also be conscious of what is a reasonable or normal price for the product.

An advantage of using competitive pricing is that it is simple and requires minimal effort. By setting prices that are in line with rivals, the business can remain competitive. Hence, it is one of the most commonly used pricing methods. However, the main disadvantage is that the business needs another way to attract customers, by using non-price methods to differentiate itself in a highly competitive market, such as advertising (to raise brand awareness) and providing superior customer service. This will clearly add to the firm's costs.

(viii) Contribution pricing (HL only)

Contribution pricing involves setting a price based on the direct costs of producing a product. Hence, the contribution per unit is the difference between the selling price and the direct cost of production. The aim is to ensure the selling price generates an acceptable contribution towards covering the fixed costs of the business.

Contribution refers to the amount left over from the selling price after deducting all direct costs of production (see Unit 5.5). The surplus is then used to contribute towards paying the firm's fixed or indirect costs of production. For example, suppose a product had a selling price of $8 and direct costs are $3 per unit. The contribution per unit is therefore $5 (selling price minus unit variable costs). Hence, each item sold enables the firm to contribute $5 towards paying its fixed costs. If the fixed costs amount to $500 per time period, the firm makes a profit once it has sold more than 100 units ($5 × 100 units).

HIGHER LEVEL

Exam tip ! - Worked Example

Suppose a single-product firm has the following costs and revenues:

- The direct costs of producing each unit of output = $25
- The business has indirect costs = $100,000
- Sales volume forecast = 10,000 units if the product is priced appropriately.

To determine the minimum selling price:

- The minimum price must cover both the direct cost ($25) and the indirect costs
- As sales volume is forecast to be 10,000 units, the firm needs a contribution per unit of $10 (i.e., 10 × 10,000 = $100,000)
- As the contribution per unit needs to be $10, the firm's selling price must be $35 (i.e., $10 + $25 = $35).

Hence, the minimum selling price must be $35. Any price set above $35 will enable the firm to earn a profit, assuming the business can still sell all 10,000 units of output at that price.

Refer to Chapter 57 for further details and numerical examples of contribution (which is part of the Business Management Toolkit for HL students).

The main advantage of contribution pricing is that it ensures the selling price is set high enough to cover both direct costs and contributes to the payment of indirect costs. Essentially, contribution pricing ensures a business does not make a loss each time it makes a sale. This is particularly important when customers want to place a large order at a discounted price per unit.

A limitation of contribution pricing is that allocating indirect costs between different products can be subjective, which is deemed to be unfair or inequitable. In addition, the business still needs to double-check the resulting contribution price to ensure that it remains competitive.

For multi-product firms, each product in the product range that is sold will contribute a proportion to the payment of the firm's overall fixed costs, rather than any single product being accountable for all the indirect costs. Hence, contribution pricing allows a business to set different prices for different products based on their level of contribution.

(ix) Price elasticity of demand (HL only)

Price elasticity of demand (PED) measures the degree of responsiveness of demand for a product due to a change in the price of that product.

- If there is a relatively small change in quantity demanded following a change in price, then demand is said to be **price inelastic,** i.e. customers are not very responsive to changes in price. This could be due to a lack of substitutes being available or a high degree of brand loyalty.

- Demand is **price elastic** if there is a relatively large change in demand following a change in the price, i.e. customers are highly responsive to price changes.

Note that it is not necessary for Business Management students to calculate PED. However, a basic understanding of the calculation is useful for consolidating knowledge of this pricing method. The formula for calculating PED is:

$$\frac{\textbf{Percentage change in Quantity demanded}}{\textbf{Percentage change in Price}}$$

or in annotation form, PED equals:

$$\frac{\%\triangle Q^D}{\%\triangle P}$$

The calculation of PED gives one of three possibilities:

- If PED is less than 1, then demand is **price inelastic**, i.e., relatively unresponsive to changes in price as the percentage change in demand is lower than the percentage change in price. Therefore, a business can increase sales revenue by increasing price.

- If PED is equal to 1, then demand is of **unitary price elasticity**, i.e., a change in price leads to a proportional change in the quantity demanded. hence a change in price does not lead to any corresponding change in sales revenue.

- If PED is greater than 1, then demand is **price elastic**, i.e., demand for the product is relatively responsive to changes in its price. Therefore, a business can increase sales revenue by reducing price.

HIGHER LEVEL

Worked Example of calculating PED

Suppose at $7 per ticket the demand for movies at a cinema is 4,000 per week. If the cinema raises its price to $8 per ticket and observes that demand falls to 3,000 per week, what is the value of PED?

- First calculate the *percentage change* in demand: i.e. demand has fallen by 25% from 4,000 to 3,000 tickets per week.
- Next, calculate the percentage change in price (which caused the demand to fall): i.e. prices rose by 14.28% from $7 to $8 per ticket.
- Hence, PED = 25 / 14.28 = **1.75**

As PED is greater than 1.0, demand for cinema tickets is said to be price elastic, i.e. customers are highly responsive to the increase in price. This means there is a larger fall in the level of demand relative to the increase in price.

Exam tip !

Note that PED is not technically a 'pricing method' but knowledge of this enables businesses to have a better understanding of the market and to devise appropriate pricing strategies.

Knowledge of PED can provide managers with valuable information about how sales revenue is likely to change if prices are adjusted. This information can be used by decision-makers in several ways, such as:

- Helping firms to decide on their pricing policy, e.g., a business with price inelastic demand for its products is likely to raise prices. For example, airlines hike their prices during school holiday seasons, partly because there is increased demand and largely because firms know that the degree of sensitivity of demand to changes in price during peak periods is lower.
- Determining which products are most affected by a downturn in the economy, e.g., luxury products are likely to have a high PED, so sales tend to suffer most during a recession.
- Predicting the effects of exchange rate fluctuations, e.g., exporters will generally benefit from lower exchange rates as their prices become more competitive (so long as the PED for exports is price elastic).
- Helping governments to determine the optimum level of taxes to impose on certain products, e.g., price inelastic products such as petrol and tobacco tend to be heavily taxed as demand is price inelastic. Whilst (price inelastic) demand for such products is not significantly affected by higher prices caused by the tax, the government manages to raise large sums of tax revenues to fund its expenditure.

Theory of Knowledge (TOK)

Can we ever know if the prices charged by businesses are ethical? Does this matter?

Marketing

Question 28.4 - Price elasticity of demand

(a) Explain whether the price elasticity of demand (PED) for each of the following products is relatively price elastic or inelastic. You will need to justify your answers

i Petrol *[2 marks]*
ii Bananas *[2 marks]*
iii Tobacco *[2 marks]*
iv Smartphones *[2 marks]*

(b) It is not uncommon for governments across the world to raise the taxes imposed on the sale of tobacco, alcohol and petrol, often on a yearly basis. Explain **two** reasons for this. *[4 marks]*

HIGHER LEVEL

Question 28.5 - The business of music concerts



It is common knowledge that the price of a concert ticket keeps going up. Elton John fans in the UK paid between £290 to £744 ($406 to $1,042), with an additional £13 ($18.2) booking fee for his "British Summer Time" concert in Hyde Park, London in June 2022. The public opinion is split – some think such prices are an outrage whilst others think it represents good entertainment value.

The demand for concerts of the world's top music celebrities has meant that rock and pop stars can make huge amounts of money from each concert they do, especially due to the **price inelastic demand** for many concert tickets. Sir Elton John's "Farewell Yellow Brick Road" tour has grossed more than $358.6 million.

However, it is Ed Sheeran who holds the all-time record for top grossing world concert tour, with gross ticket sales of more than $776.2 million for his ÷ Tour (pronounced "Divide Tour"). Some analysts argue that music artists have been forced into doing concerts to combat the decline in their potential earnings caused by people illegally downloading music from the internet. Whatever the reasons, ever since the 1980s, concert ticket prices in the USA and Europe have soared at rates higher than inflation.

(a) Define the term *price inelastic demand*. *[2 marks]*

(b) Explain **two** reasons why music fans might be prepared to pay such high prices for concert tickets *[4 marks]*

(c) Explain **two** suitable pricing methods that concert organizers can use to sell tickets for music events. *[4 marks]*

(d) Discuss whether the demand for concert tickets is generally price elastic or price inelastic. *[10 marks]*

HIGHER LEVEL

Business Management Toolkit

Discuss how the Boston Consulting Group matrix (see Chapter 47) can help with a firm's pricing decisions.

Business Management Toolkit

Discuss how knowledge of Porter's generic strategies (see Chapter 53) can support managers in their pricing decisions, such as the use of penetration or predatory pricing strategies.

Price and the key concepts

In reality, the prices set by a business will usually consist of a combination of various pricing methods. It is vital that the pricing method(s) adopted by the business provides adequate profit for all products in its product portfolio in a sustainable way. It is also important that the pricing of a new product does not destroy profit margins on more established products. However, the pricing decision must be consistent with the organization's marketing objectives, such as penetration pricing might be used to establish or gain market share.

Whilst there is scope for pricing methods to be creative (and beyond the pricing methods specified in the syllabus), pricing decisions must also be consistent with all other aspects of marketing, such as:

- *Marketing planning* (see Chapter 24) - Pricing decisions need to consider the nature of different target markets. Segmentation data such as **changes** in income levels and demographic trends can prove useful in setting suitable prices.
- *Product* (see Chapter 27) - Features of a product such as the quality and its **creative** design and functionality also affect the choice of pricing method. Innovative products can demand a premium price, whereas 'me-too' products (those designed to be similar to popular products made by other businesses) can only command lower prices.
- *Promotion* (see Chapter 29) - The type of promotional methods used to market a product affects the costs, which in turn influences the price. For example, mass media television advertising or expensive celebrity endorsements ultimately result in higher prices being charged to customers. Highly **creative** promotional methods that capture the attention and engagement of customers will tend to allow businesses to charge higher prices.
- *Place* (see Chapter 30) - The choice of distribution methods will also affect prices, e.g. cosmetics sold through mail order catalogues are priced differently from those sold at exclusive cosmetic boutiques. The more intermediaries that are used, the greater the costs and hence the higher the price tends to be. This has incentivised many businesses to **change** their business model and pricing strategies to rely more on e-commerce.

In addition to marketing issues, there are other factors that can affect a firm's choice of pricing methods:

- *The nature of the business* - Profit maximising businesses with significant market share are likely to use high pricing strategies, such as premium pricing and dynamic pricing. By contrast, cost-based methods may be more appropriate and **ethical** for non-profit organizations.
- *The nature of barriers to entry* - This refers to the degree of competition within the industry, i.e. high entry barriers limit competition in an industry, but allow existing businesses to charge higher prices. By contrast, businesses operating in highly competitive markets may need to be more **creative** and take extra notice of the prices being charged by their rivals.
- *Business image* - Organizations with a reputable and prestigious corporate image can charge higher prices. By contrast, firms with inferior products or brands will charge lower prices in a less **sustainable** way.
- *Business costs* - Whatever strategy is chosen, a business must cover its costs of production in the long term to ensure the business operates in a **sustainable** way. For example, the high production costs of hand-made silk rugs or bespoke tailor-made suits mean that premium prices need to be charged.
- *The state of the economy* - Businesses need to be flexible and adapt pricing methods in relation to **changes** in the state of the economy. For example, most businesses tend to reduce prices during an economic recession (see Chapter 46), especially those that sell high-quality, luxury products.

ATL Activity (Research and Thinking skills)

Investigate the role of creativity in the pricing decisions for a business or businesses of your choice. An example is shown below for illustrative purposes.



Figure 28.6 - A creative pricing method?

Exam tip !

Exam questions often require candidates to suggest and justify suitable pricing strategies that can be used by a business to enter new markets. Rather than simply explaining the various types of pricing methods in the syllabus, it is more important to put these into the context of the organization. It might be appropriate to consider several issues first, before advising suitable pricing methods, such as:

- Although the market is 'new' for the organization in question, there might be other established businesses already in the market. Hence. predatory pricing might not be suitable, where is competitive pricing (HL only) might be more appropriate.
- Unless the product is original and innovative, customers will already have perceptions about what the right or optimal level of prices ought to be.
- For some products, dynamic pricing is highly suitable whereas loss leader pricing works better for other Goodson services.
- What sort of image does the business want to portray? Clearly, the pricing method used for high quality and specialist products will be different from that used for mass market products with plenty of substitutes.
- Finally, it is important to consider the likely reaction and consequences of competitors to the pricing methods used by a business. If low prices are used and this sparks off a price war, then most businesses will tend to lose out.

Question 28.6 - Virgin Australia Airlines

Virgin Australia Airlines was the creation of Sir Richard Branson, founder and CEO of the Virgin Group. Branson and the airline's founding CEO, Brett Godfrey, launched the airline carrier in 2000 to enter the Australian market. Initially set up as a low fare carrier and with just two aircraft, the company only flew between Brisbane and Sydney. Since then, it has become Australia's second largest airline, covering all major cities in Australia. Virgin Australia Airlines is the Virgin Group's largest airline by fleet size.

To cut **direct costs**, customers of Virgin Australia Airlines pay for their in-flight meals and drinks. To enhance the convenience for customers, the airline was also one of the first in the industry to use an e-ticketing system (a telephone and internet-based ticketing system).

(a) Define the term *direct costs*. *[2 marks]*

(b) Describe **two** potential pricing strategies that airline companies can adopt when entering a new market. *[4 marks]*

(c) Evaluate **two** possible pricing methods that established airline carriers such as Virgin Australia Airlines could use to increase their sales revenue. *[10 marks]*

HIGHER LEVEL

Key concept

With reference to an organization of your choice, discuss how **change** has affected its pricing methods.

Key concept

With reference to an organization of your choice, discuss how **ethics** have influenced its pricing methods.

Business Management Toolkit

Discuss the importance of pricing decisions in a business plan (see Chapter 48).

Business Management Toolkit

Discuss how knowledge of contribution analysis (see Chapter 57) can support the pricing decision of a business.

Despite the huge importance placed on pricing methods, it is important to note that businesses are also likely to use **non-pricing strategies** to market their goods and services. These strategies can take the form of promotional methods such as advertising (see Chapter 29), branding (see Chapter 27), gift vouchers, customer loyalty programmes (see Chapter 43) and packaging. Note that price and marketing are integrated as part of the overall strategy for a business; after all, no amount of price discounts alone can sell a product that does not meet the needs or wants of consumers.



Figure 28.6 -Pricing methods are part of a firm's overall marketing strategy

Key concept

Discuss the role of **creativity** in pricing methods used by non-profit organizations.

REVIEW QUESTIONS

1. What is meant by 'price'?
2. Explain why the price decision (deciding on the 'right' price) is such an important task.
3. What is 'mark-up'?
4. What is penetration pricing?
5. Why do some businesses use loss leaders?
6. What is predatory pricing and why might this be illegal in some countries?
7. Why might customers not necessarily benefit from predatory pricing methods, such as price wars?
8. Why do some businesses use premium pricing?
9. What is dynamic (surge) pricing? (HL only)
10. Why do so many businesses use competitive pricing? (HL only)
11. Why might contribution pricing be applicable to almost all businesses? (HL only)
12. How does knowledge of price elasticity of demand help managers and entrepreneurs? (HL only)

KEY TERMS

Competitive pricing is the practice of a business setting the price of its goods or services at the same or similar level to that of its competitors.

Contribution pricing is the practice of setting the selling price of a product higher than the direct costs of production per unit in order to ensure there is a positive contribution made towards payment of indirect costs.

Cost-plus pricing (or **mark-up pricing**) involves adding a percentage or specific amount of profit to the cost per unit of output in order to determine the selling price.

Dynamic pricing is the practice of varying the price of a good or service to reflect changing market demand, such as during different times of the day or year.



Figure 28.7 -Taxi operators often use dynamic pricing

Loss leader pricing involves setting the price of a good or service below its costs of production. The purpose is to entice customers to buy other products with high profit margins in addition to purchasing the loss leader product.

Mark-up refers to the extra amount charged by a business on top of its unit costs of production in order to earn a positive profit margin. The mark-up can be expressed as an absolute amount (e.g. $10 per unit) or as a percentage of the cost (e.g. 75% per unit).

Penetration pricing involves setting low prices in order to gain entry into a new market. Once the product or brand has established market share, prices can be raised.

Predatory pricing involves temporarily setting prices so low that competitors, especially smaller businesses, cannot compete at a profitable level.

Premium pricing is when the price of a good or service is set significantly higher than similar competing products, usually because the product is of higher quality or is sufficiently unique to justify the premium price.

Price refers to the value of a good or service. It is the amount paid by a customer to purchase the product.

Price elasticity of demand (PED) measures the degree of responsiveness of demand for a product due to a change in the price of that product.

Price wars involve businesses competing by a series of continuous and/or intensive price cuts to threaten the competitiveness of rival firms in the market.

Pricing methods are the various methods of setting the amount that customers pay for certain goods and services.

Topic 4: Marketing

Chapter 29

Unit 4.5 - The seven Ps of the marketing mix (3) - Promotion

"Advertising is the art of convincing people to spend money they don't have for something they don't need."
- Will Rogers (1879 - 1935), American comedian and actor

Contents

4.5 The seven Ps of the marketing mix (3) - Promotion	
SL/HL content	**Depth of teaching**
The following aspects of promotion: • Above the line promotion • Below the line promotion, and • Through the line promotion	AO2
Social media marketing as a promotional strategy	AO3

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Promotion

The following aspects of promotion: (i) above the line promotion, (ii) below the line promotion, and (iii) through the line promotion.
AO2
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Promotion refers to methods of communicating marketing messages to existing and potential customers, usually with the intention of selling a firm's products. Examples include advertising, social media marketing, and raising publicity (awareness). Some types of promotion are paid for (such as mass media advertising) whilst some are not (such as word of mouth promotion).

There are five key objectives to any promotional strategy: to *inform*, to *persuade*, and to *remind* the market about the firm's goods and services, as well as to *develop* brand awareness and *attract* the attention of customers. Promotional activities aim to:

- **Inform** - Informative promotion activities aim to alert the market about a firm's products, especially new or updated goods and services. Promotion might include information such as product features, functions and price. It is often based on providing facts and figures about a business or its products. The aim is to give customers sufficient information to positively influence their purchasing decisions.
- **Persuade** - Persuasive promotion activities aim to convince or encourage customers to make a purchase, to switch from rival products and to enhance brand loyalty. To entice customers to buy their products, businesses might adopt product differentiation strategies (see Chapter 27), such

as branding, to create a unique identity or to enhance the product's appeal. Successful persuasion can also generate impulse buying - when customers make a purchase without having planned to do so as there is a subconscious urge to buy the product.

- **Remind** - Reminder promotion refers to techniques used to retain customer awareness of, and interest in, an established product. Reminder promotional techniques are suitable for products that are in the maturity or saturation stages of their product life cycle (see Chapter 27). Market leaders such as McDonald's and Coca-Cola often use this form of promotion.

- **Develop** - Brand development promotional strategies help to build awareness, recognition, and loyalty to the business, its products, and its brands. It can be expensive for a business to earn a customer, so brand development strategies (see Chapter 27) are also important for retaining customers.

- **Attract** - Promotional activities that aim to attract the attention of customers is a vital aspect of marketing. In particular, such promotional activities focus on attracting customers to the entire product range or family brand of products offered by the business.

Exam tip !

These five goals of promotion can be remembered by the mnemonic RAPID:

- **R**emind
- **A**ttract
- **P**ersuade
- **I**nform, and
- **D**evelop

The vast majority of promotions are of the persuasive kind. However, most promotional campaigns contain an element of all three types of promotion. Governments and non-profit organizations account for the majority of informative-driven promotional campaigns.

Case study 29.1 - The Spider-Man movie franchise

The producers of the first *Spider-Man* movie spent $50 million on its promotional campaign in 2002. This spending had to be justified and the success (or otherwise) of this has to be measured. The movie brought in box office sales of $821 million. The sequel, *Spider-Man 2,* had sales of $789 million. *Spider-Man 3* was also a huge success, costing $258m to make, but raking in $891 million (a return of 245%)! In 2021, the release of *Spider-Man No Way Home* became the first movie during the COVID-19 pandemic to exceed $1 billion in box office sales.

Common mistake

Too often, students state that promotion is the same as (another word for) advertising. Advertising is a method of informative and/or persuasive promotion that is usually paid for. The aim of commercial advertising is to raise the level of demand for a firm's products.

So, whilst advertising is indeed a form or promotion, the latter is far more and includes all forms of marketing that inform, persuade and remind customers about the firm's goods and services. It is about attracting customers to the business and developing the corporate image of the business, its products and its brands.

Above the line promotion (AO2)

Above the line (ATL) promotion is any form of paid-for promotional method through independent mass media sources (such as television, magazines, and the radio) to promote a business, its products or its brands. The business passes control of ATL promotion to specialist external organizations such as advertising agencies. The main methods of ATL promotion include: (i) television advertising, (ii) radio advertising, (iii) cinema, (iv) newspapers, (v) magazines, and (vi) outdoor advertising.

(i) Television advertising

The first American TV advert appeared in 1941. UK television adverts premiered in 1955 and had a profound impact on the marketing industry. According to the Broadcasters Audience Research Board (www.barb.co.uk), the UK TV advertising industry is worth over £4.35 billion per year ($6.1bn per year or over $16.7 million every day). The fact that expenditure on TV advertising is such big business, and that it exceeds spending on most other forms of promotion, suggests it has huge advantages.



Figure 29.1 - TV advertising is big business

Advertising on TV exploits the power of combining sound and moving images to bring about extremely powerful messages to audiences. TV adverts can also be designed to meet specific needs, such as adverts aimed at children being aired during children's television programmes. With advances in technology, such as high-definition digital television, it is possible to broadcast TV adverts to a global audience.

However, the major drawback is the huge costs of producing and broadcasting television commercials. Media specialist and author, Frank Dane explained this by stating "*Time is money, especially when you are talking to a lawyer or buying a commercial.*" Television companies sell 'advertising slots' to businesses based on the level of demand (peak-time slots will obviously sell for a higher amount). Hence, marketers must try to get their marketing message across in an incredibly short time frame, usually within 30 seconds. In fact, the cost of a 30-second weekend TV advertising spot during peak time in the UK, including production costs, can exceed $350,000.

Case study 29.2 - The Super Bowl



The annual Super Bowl (American Football), with its 115 million viewers, is America's most watched sporting event and most-watched US television programme. This creates huge promotional opportunities for businesses with large advertising budgets. In 2021, the average cost of a 30-second advert during the Super Bowl was $6 million! This price has soared by 50% since 2013 due to popular demand for advertising slots. The most popular adverts aired during the Super Bowl earn a place in advertising history, being broadcast on television and the Internet for years to come.

ATL Activity 29.1 (Thinking skills)

Visit https://dailycommercials.com/ for some of the latest and good-humoured television adverts. You can also view a collection of the most recent adverts from the Super Bowl here. As we watch these commercials, try to get some insight into cultural differences by viewing the adverts from different countries.

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(ii) Radio advertising

As with television advertising, radio time slots are sold to businesses. The peak listening times are in the morning and evening rush hour periods. Commercial radio stations require a license to broadcast. Their activities are monitored and regulated by a government agency. The content of radio advertisements in most countries must be legal, decent, honest and truthful.

Radio advertising is able to reach an extremely large audience, yet it is significantly cheaper than TV advertising. Unlike TV advertising, radio commercials do not rely on viewers having to be immobile in front of a TV screen. Instead, radio listeners are exposed to the promotions whilst they continue to do other

things, such as driving, eating a meal or even whilst studying or working. Advances in technology, such as wireless broadband, mean that digital radio commercials can be broadcast to almost anyone around the world.

The main drawback of radio advertising is that it can only communicate audio messages, i.e. there is no visual impact. Research has shown that people can retain verbal messages better when there is a visual stimulus. Another related disadvantage is that audiences have lower attention levels compared to TV adverts which exploit the dynamics of moving images.



Figure 29.2 - Radio advertising is a form of ATL promotion

(iii) Cinema

Statistics show growing visitor numbers at cinemas around the world, which has attracted more marketers to use the cinema as an advertising medium. For example, data from the UN Institute for Statistics shows that China's box office revenues increased by 731% in the first 5 years following the global financial crisis of 2008. In the UK, annual box office revenues averaged over £1.156 billion ($1.62 bn) for the ten years prior to the 2020 global pandemic that caused cinemas across the country to close due to lockdown laws.

A key advantage of using cinema advertising is that audiences can be directly targeted. Promotion can be tailored to specific market segments (such as the genre of film and age groups of the cinemagoers). The size of cinema screens can exert more impact compared to other forms of promotion, especially with the increased popularity of 3D movies. Furthermore, unlike television or radio commercials, marketers have a captured audience as it is much harder for viewers to ignore or switch off the adverts (especially as most cinemagoers perceive the commercials and trailers to be part of the overall cinema experience). The main drawback is its limited audience size compared to that of radio listeners and television viewers.

(iv) Newspaper advertising

Newspaper advertising has the advantage of potentially reaching a wide audience yet is much cheaper than using TV advertising. Unlike radio adverts, newspaper adverts can be referred to at a later date meaning that important information can be retained. Although television and radio commercials today can be targeted at specific market segments (at least to some extent), newspaper adverts can target different markets better. For example, teaching jobs are advertised in *The Times Educational Supplement*, a specialist newspaper for educators, and on its website (www.tes.co.uk). As newspaper firms have their own dedicated websites, they can have a much wider reach, which makes (digital) newspaper advertising more attractive.

The main constraint of newspaper advertising is the high costs, particularly for small businesses. Newspaper firms charge higher prices for adverts with colour, images or photos. Most newspaper companies base their charges on the size of the advert whilst others charge on the basis of the number of words, letters or characters used in the advert. For a newspaper advert to stand out from the many others that appear, businesses may need to spend a lot more money than their rivals to ensure that readers are attracted to their advert. Unlike other print media, such as magazines or outdoor posters, newspapers have a very short shelf life; people will not usually read yesterday's 'news', so many adverts are simply left unseen and unnoticed.



Figure 29.3 - Newspapers are still a popular platform for ATL promotion

CORE

Marketing

(v) Magazines

Promotion in magazines has the advantage of being able to use high definition, photo-quality colour images to capture the attention of readers. Targeting the right market segment is possible through the use of specialist magazines such as *Car, Brides, PC Gamer* and *Vogue*. Adverts in magazines can be referred back to at a later date, which helps with brand recall and retention of marketing messages. Magazines also have a longer shelf life than newspapers.

One downside to using magazine promotion is that it is static. Hence, it is quite usual for a business to place several different adverts in the same magazine (think of all the various adverts used by fashion designers in clothing magazines, for example). Also, readers are bombarded with advertisements (known as **advertising clutter**) so may unintentionally miss or deliberately ignore, the adverts. A third disadvantage is that there can be a long lead-time between submitting an advert and its actual publication in a magazine (even in the case of digital magazine publications). This means there is a delayed period when sales are potentially lost unless additional methods of promotion are used.

(vi) Outdoor advertising

Outdoor advertising refers to the use of commercial billboards, banners, and posters to promote a business, its products or its brands. These can often be seen at sporting events, in shopping malls, at the roadside and on vehicles (such as buses, trains, and taxis). Outdoor advertising is commonly used by car manufacturers, food producers, clothing firms and businesses involved in leisure and tourism.

With advances in technology, the ordinary outdoor advert has been transformed to billboards that automatically rotate (thereby increasing the number of promotions that can be shown on each physical billboard) and digital billboards that can combine moving images and sound. This has given outdoor advertising a dynamic dimension. Another advantage is that there is a high rate of exposure, especially if businesses are able to use the same adverts in many different locations.

However, a disadvantage of outdoor advertising is the difficulty in monitoring and measuring its effectiveness because targeting specific market segments is difficult (making it only suitable for promoting mass market products). Traditional billboards are also prone to damage caused by bad weather, vandalism and graffiti. Furthermore, there can be high levels of competition in terms of advertising clutter - central business districts such as New York City, Tokyo and London are swamped with billboard adverts. In São Paolo, Brazil, outdoor advertising has been outlawed because it had become so overused that critics argued it created 'advertising pollution', i.e. the billboards became too much of an eyesore for the city's 22 million inhabitants.



Figure 29.4 - Advertising clutter can be an eyesore

Theory of Knowledge (TOK)

To what extent is dynamic pricing unethical and inequitable?

In summary, the main advantage of ATL promotion is that it reaches a potentially large number of customers. Research has shown that customers tend to take more notice of ATL promotion as they are more interesting, engaging and appealing. However, ATL promotion is highly expensive and might not even appeal to the audience. For example, many outdoor billboard adverts go unnoticed because they do not specifically target a market segment. Many adverts are ignored because people switch channels during television and radio commercial breaks; readers often take no notice of adverts in magazines and newspapers; and people frequently complain about the number of pop-up adverts on the Internet.

Theory of Knowledge (TOK)

British author Norman Douglas (1868-1952) said that *"You can tell the ideals of a nation by its advertisements."*

Use real-world examples to determine the extent to which you agree with this statement.

Question 29.1 - The entertainment industry



The entertainment industry is a huge business - just consider the immense popularity of streaming services and TV shows such as *Squid Game* and *Money Heist*. The movie and music industries are constantly using **above the line** promotional strategies to market their latest products. Trailers (previews) for the latest movies and music albums are frequently aired on television, whilst posters for these releases appear all over glossy magazines, in newspapers and on billboards. There are even dedicated Internet websites, set up to promote the launch of a movie or music album. Most albums and movies tend to have a short life span, whilst a special few, such as *The Beatles* albums and the *Star Wars* movies, have entertained people since the 1960s and 1970s respectively.

(a) Define the term *above the line* (ATL) promotional strategies. *[2 marks]*

(b) Examine **two** reasons for using ATL methods to promote the entertainment industry. *[6 marks]*

Below the line promotion (AO2)

CORE

Below the line (BTL) promotion refers to the use of non-mass media promotional activities, allowing the business to have direct control. Unlike ATL promotion, this means that no commission has been paid to external media agencies. BTL promotion specifically targets individual market segments as clearly identified potential customers. These methods tend to be relatively cheap in relation to methods of ATL promotion.

The main BTL promotional strategies, which are outlined below, include: (i) direct marketing, (ii) personal selling, (iii) sales promotions, (iv) point of sales promotion, (v) publicity and public relations, (vi) trade shows, (vii) sponsorships, (viii) word-of-mouth marketing, (ix) guerrilla marketing and (x) and packaging.

Please do note that no specific examples of ATL or BTL promotional strategies are listed in the syllabus.

Marketing

(i) Direct marketing

Direct marketing refers to promotional activities that aim to sell a product straight to a customer rather than using an intermediary. For example, property developers might use their database containing information about previous clients (who may be interested in purchasing another property), rather than paying real estate agents to find customers. Direct marketing techniques include making telephone calls (known as **telemarketing**), sending email adverts to potential clients, and distributing **direct mail** to customers. Direct mail is a type of direct marketing that involves the use of postal correspondence for promoting an organization's goods and/or services in an attempt to convince the targeted audience to buy the firm's products.

An advantage of direct marketing is that the business keeps a larger share of any financial returns as there are no intermediaries, such as advertising agents, to pay. In addition, the business is free to promote its products in a way that it sees fit, rather than passing on control of this to an external agency.

A major drawback of direct marketing is the cost of producing and distributing promotional materials such as leaflets, brochures and catalogues. Research also shows that most people ignore and dispose of 'junk' (unsolicited) mail, do not welcome unwarranted telephone calls from telesales personnel, and do not appreciate emails regarded as spam advertising. Furthermore, direct marketing does not always reach the right audience, and hence represents a waste of resources. An example would be people who do not have young children but still receive mailed materials promoting schools, toys, children's books and clothes for toddlers.

(ii) Personal selling

Personal selling refers to promotional techniques that rely on sales representatives directly helping and persuading customers to buy. Examples include sales presentations, face-to-face meetings with clients and door-to-door salespeople. For instance, insurance and financial planning companies often use brokers (agents) who visit clients in person to promote their products and services.

A key benefit of using personal selling is that it can be tailored to the individual needs and preferences of the customer. The salesperson and the customer engage in dialogue to establish the customer's views and preferences, to answer any questions and to promote the organization's products to the customer. Personal selling can develop customer engagement so also helps the business to build a positive, trusting and long-term relationship with customers.

A disadvantage of using personal selling is that sales agents can be expensive to hire. For example, sales representatives at health and beauty counters in large department stores are skilled in their product knowledge and craft, so are therefore remunerated accordingly. They also earn good rates of commission (see Chapter 10) on the sale of each item sold.

(iii) Sales promotions

Sales promotions are temporary methods used to boost sales and attract new buyers. They involve short-term incentives designed to stimulate interest in a product. Sales promotion can help businesses to gain a short-term competitive edge, to get rid of excess or old stock and to build brand awareness. Examples include:

- BOGOF (buy one get one free) deals, which are often used to get rid of excess stock or sometimes used as loss leaders (see Chapter 28).
- Competitions (contests) that give people the chance to win a prize, such as a free holiday or a car.
- Free gifts to customers making a purchase, such as complimentary packs of coffee pods when buying a coffee machine.
- Free installation and a period of complimentary service when customers subscribe to broadband or online streaming services.
- Free samples of products, such as shampoo and perfume sachets in department stores or free food and wine tasting in large supermarkets.

Question 29.2 - Kim Do Yi

Kim Do Yi Ltd. (KDY) is a martial arts organization based in Hong Kong and New York City. It was established in 1995 by Master Instructor Rickie Chan Ka Ching. The organization specialises in the Korean martial arts of Taekwondo and Hapkido. It is affiliated to the World Taekwondo Federation (the governing body of Olympic-style Taekwondo).



KDY's core **target market** is children of primary and secondary school age. KDY does not have its own kwans (training studios), preferring instead to hire venues in numerous locations throughout Hong Kong and New York City. KDY believes this approach keeps costs to a minimum and makes access easier and cheaper for its customers.

(a) Define the term *target market*. *[2 marks]*

(b) Explain why promotion is important to a business such as KDY. *[4 marks]*

(c) Recommend a suitable promotional mix for KDY. *[10 marks]*

- Money-off coupons (discount vouchers) offering customers a discounted price on a product. These often appear as cut-out coupons in magazines and newspapers or online QR codes.

Essentially, they are short term promotional tactics used to entice customers to buy a certain product. Sales promotions can be beneficial to a business because they boost sales (at least in the short run). They can also sway customers away from rival businesses and brands. More importantly, sales promotion encourages action (the desire to make a purchase), rather than only informing or reminding customers about a product.

However, the main drawback of sales promotions is the cost. Free samples, discounts, prize draws, and so forth all add to the marketing costs of a business. Hence, sales promotions can reduce the profit margin on each product - the greater the cost, the lower the profit margin tends to be. Therefore, marketing managers need to carefully monitor the progress of the sales promotion campaigns to ensure that costs are kept under control. In addition, sales promotions are only short-term tactics, so additional BTL strategies still need to be used.

(iv) Point of sales promotion

Point of sales refers to the promotion of a product at the place or location where the customer buys the product. Supermarkets use this method extensively - whilst customers are queuing at the checkouts, they are exposed to the promotion of products such as batteries, confectionary items and magazines. Large and eye-catching in-store displays, stands and posters are used to encourage **impulse buying** (attracting customers to buy products that they had not intended to).

(v) Publicity and public relations (PR)

Publicity is the process of promoting a business and its products by getting media coverage without directly paying for it. For example, famous celebrities are often snapped wearing designer labels, which gives those brands free publicity in the media. Ferrari found that it was cheaper to give away one of their cars to football celebrity David Beckham than to promote its vehicles on television. The subsequent media publicity that was generated was much more favourable than Ferrari could have hoped for from any commercial advert.

Public relations refer to marketing activities aimed at establishing and protecting the desired image of an organization. PR is about getting positive media coverage, usually without directly paying for it (otherwise it would be considered as ATL promotion). Specialists in PR get the media to report events in a positive way and from the business's point of view. Examples of PR include:

- having a launch party for a new product
- organizing press conferences
- radio or television interviews or appearances on talk shows
- book signing events
- publicity events with endorsements by celebrities or famous people, and
- making prominent donations to charities and other good causes.

However, PR is often a long-term and on-going marketing strategy beyond just promotional strategies. PR experts are heavily relied upon when a business faces a crisis (see Chapter 41). They try to get the mass media to cover stories about the business in a positive, sympathetic and comforting way.

(vi) Trade shows

Trade shows (also referred to as **trade fairs**) enable exhibitors to conduct live demonstrations to showcase and promote their products. For example, IBID Press attends the IB's Global Conferences to promote their textbooks to coordinators and teachers following the IB Diploma Programme at their schools. Trade shows are also popular with car manufacturers to showcase the latest models of their vehicles (see Question 29.3 - The Paris Motor Show).

The main advantage of using trade shows is that the exhibitions and events attract a large audience of targeted customers. This can certainly help the business with promoting its latest products to the right people. However, there is likely to be competition as rivals also make an appearance at these events. Exhibitors also need to consider the cost of joining trade shows. For example, the starting cost for an exhibitor at an IB Global Conference in 2019 (pre-pandemic) was $2,200 plus $895 per additional exhibitor attendee.

Question 29.3 - The Paris Motor Show



The Paris Motor Show is one of the top auto shows in the world. Established as the world's first motor show back in 1898, it is a public exhibition of current, debut and concept cars. The bi-annual event attracts all the major motor manufacturers that regard the show as vital for **promotion** of their cars. Mass media coverage of the event ensures that the major exhibitors get maximum exposure and publicity.

(a) In the context of marketing, define the term *promotion*. *[2 marks]*

(b) Explain why trade shows are important for businesses such as car manufacturers. *[4 marks]*

(c) Explain **two** reasons why car manufacturers use trade shows such as the Paris Motor Show rather than direct marketing to exhibit debut (new) cars. *[4 marks]*

(vii) Sponsorships

Sponsorship involves a business providing financial funds and resources to support an event or another organization in return for publicity and prime advertising space and prominent publicity. For example, Arsenal Football Club received a €132m ($178m) sponsorship deal in 2006 with Emirates Airline. In return, Arsenal named its new stadium *The Emirates Stadium*. In 2012, Emirates Airline agreed a further £150m ($245m) sponsorship deal. Then in 2018, this deal was extended until 2024 as part of a sponsorship agreement worth over £200m ($290m). Emirates Airline also sponsor top-flight teams such as Real Madrid, AC Milan, and Olympiacos FC. Other airlines that sponsor top football (soccer) clubs include Etihad Airways (Manchester City FC), Qatar Airways (FC Barcelona) and Delta Air Lines (Chelsea FC).

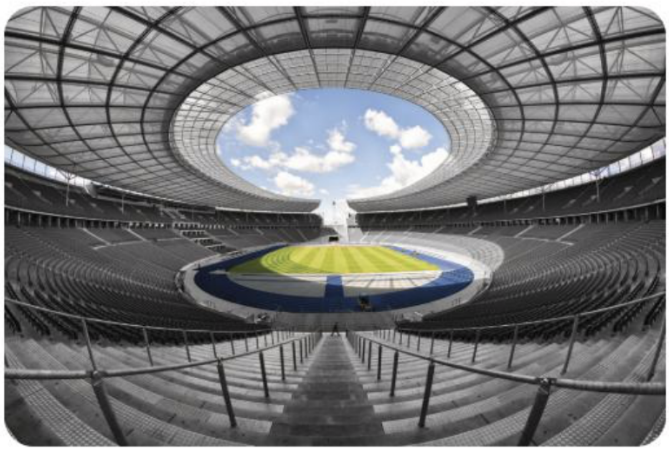

Figure 29.5 - Sporting events create opportunities for marketers and sponsors

Question 29.4 - Sponsoring the FIFA World Cup

According to SouthAfrica.info, the 2010 FIFA World Cup created an estimated 695,000 jobs and increased host nation South Africa's gross domestic product (GDP) by 93 billion rand ($13.4bn). The world's largest sporting event, as measured by global viewers and **sales revenue**, attracts a phenomenal amount of **sponsorship** money. Official sponsors such as Gillette, Yahoo! and Philips benefit most from having paid tens of billions of dollars to sponsor the FIFA World Cup because their products are promoted to audiences all across the world. The cumulative television audience for the tournament was reported to be in excess of 40 billion viewers in more than 200 countries according to *Forbes*.

The benefits of sponsorship were so encouraging that some of the larger multinational companies (such as Adidas, Sony, Coca-Cola, Hyundai and Emirates Airlines) had already secured sponsorship deals for the 2014 event in Brazil before the start of the World Cup in Germany, back in 2006! Adidas, Coca-Cola and Hyundai continued their sponsorship of the FIFA World Cup in 2018 in Russia. Qatar Airways also announced in 2018 that it would become the official airline sponsor of the 2022 FIFA World Cup, fittingly held in Qatar.

Source: adapted from www.southafrica.info and The World Cup and Economics 2010, Goldman Sachs

(a) Define the term *sales revenue.* *[2 marks]*

(b) Define the term *sponsorship.* *[2 marks]*

(c) Explain **two** benefits to multinational companies that sponsor events such as the FIFA World Cup. *[6 marks]*

CORE

(viii) Word-of-mouth promotion

Word-of-mouth (WOM) promotion refers to the spreading of promotional information from one person to another through verbal communications. A. Milligan and S. Smith (2002) argue in their book *Uncommon Practice*, that the fastest way to build a brand is through word-of-mouth promotion. Their research suggests that conventional ATL advertising expenditure can therefore be extremely wasteful.

Similarly, American artist Ray Johnson said that "*ordinary people can spread news faster than marketers*". Therefore, WOM promotion is possibly the most effective form of promotion as information and recommendations about a product are passed onto friends and family without any direct costs to the business. Jeff Bezos, founder of Amazon, said, "*If you do build a great experience, customers tell each other about that. Word of mouth is very powerful.*" However, it can be potentially very damaging if the word spreads that a business or its products are sub-standard. This is ever-more important in today's digital world with online platforms for sharing customer feedback.

(ix) Guerrilla marketing

Guerrilla marketing was coined by Jay Conrad Levinson in 1984, who described this form of promotion as "*achieving conventional goals, such as profit and joy, with unconventional methods, such as investing energy instead of money*". Guerrilla marketing, sometimes referred to as **stealth marketing**, uses untraditional, unconventional, and perhaps unruly but creative and original methods of promotion, on a relatively low budget. Levinson argued that a business should not simply invest money into promotion but focus instead on time, energy and imagination.

As a BTL promotional strategy, guerrilla marketing is highly suitable for businesses that operate on a tight budget. An example is the use of simple promotional messages in public lavatories (washrooms), such as in urinals or on the mirrors. Even escalators and elevators (lifts) have not managed to escape the guerrilla marketers!

Guerrilla marketing is often designed to make the audience unaware that they are being targeted and is favoured by small businesses as they cannot afford mainstream ATL promotional methods such as TV or newspaper advertising. Furthermore, the shrewd tactics used by guerrilla marketers can achieve big results. It aims to ambush or catch the attention of customers

through unusual and/or shocking techniques. The most effective guerrilla marketing strategies are simple, flexible, inexpensive and target specific market segments. Advances in technology such as the Internet have made guerrilla marketing more accessible to many businesses.

Case study 29.3 - Firefox

In 2004, Mozilla Corporation's web browser, Firefox, was rather unknown until the company used guerrilla marketing tactics and some clever public relations. The company used a fan base of volunteers who managed to generate 13 million downloads in just 45 days! The use of peer persuasion and word of mouth recommendations was far more effective than any form of ATL promotion. By the end of the first year, there had been over 100 million downloads. Just ten years later, Firefox had 500 million users around the world.

Key concept

What is the role of **creativity** in the use of effective marketing techniques?

(x) Packaging

Packaging is the art of presenting products in an advantageous way in order to improve sales. Apart from providing physical protection, packaging is also used to promote the brands and products of a business. It can be a powerful component of the marketing mix. Almost all manufacturers and retailers use protective packaging, including carrier bags, for their products, displaying and therefore promoting the brand name or logo. Customers who reuse these bags are in effect helping to promote a business after the initial purchase has been made. Additional examples include the use of special gift-wrapping services to promote the product and coffee shops that use disposable cups to promote their brand name.



Figure 29.6 - Packaging can be an effective way to promote a brand

Packaging can also be used to encourage impulse buying (unplanned purchases). For example, confectionery and other food items sold in supermarkets often have eye-catching packaging to entice customers to purchase the product.

A main drawback of packaging is the cost. Customers are the ones who ultimately pay for the privilege of attractive packaging. Environmentalists argue that marketers create excess packaging, at the cost of the environmental. Nevertheless, there is little doubt that effective packaging can also have positive impacts on prices, customer perceptions and consumer demand.

Exam tip !

Make sure you can clearly distinguish between ATL and BTL promotion. The differences include the following points:

- ATL promotion is targeted at mass market audiences; BTL promotion is at aimed at individuals.
- ATL promotion helps to raise awareness of the business, its products and its brands; BTL promotion aims to generate customer conversions to secure actual sales.
- The success of ATL promotion is harder to measure than that of BTL promotion.
- ATL methods use external agencies, and hence incur professional fees.
- Marketers have more control over BTL promotional methods.

Exam tip !

Writing your answers in context is important in the examination. Promotion on the Internet can be a form of BTL if the business has its own website and uses it for promotional reasons. It can also be a form of ATL promotion if the business pays for adverts on popular websites such as Google and Facebook.

Through the line promotion (AO2)

Through the line (TTL) promotion refers to promotional strategies that involve both above and below the line methods. This approach allows customers to engage with the product or brand in multiple ways, such as TV and radio adverts, direct sales marketing methods, social media platforms, and during a sponsored event. Hence, TTL promotion enables an integrated marketing approach where a consistent message across multiple platforms to inform, remind and persuade customers to purchase the product. Technological advances, such as social media marketing (see below), have significantly broadened the opportunities available to businesses to extend their promotional strategies and intensified the use of TTL techniques in order to build brand awareness and develop brand loyalty.

TTL benefits from the advantages of both ATL and BTL promotional methods by delivering marketing messages with a wide reach yet with focused customer engagements. This helps with *brand visibility* (getting the brand noticed and recognised) and *brand recall* (reminding customers of the benefits of the brand).

It is increasingly common for businesses to use an integrated approach involving both ATL and BTL promotional strategies, i.e. through the line promotion is commonplace. This is because each method of promotion has its own set of advantages and limitations. The important thing is to select the mixture of promotional methods that best suits the organization's particular needs and those of its customers. In devising a TTL promotional strategy, marketers consider a combination of factors, including:

- *Cost* - Although TV advertising has the highest potential reach, it is also the most expensive method. Promotion on the Internet is relatively cheap; a key reason why it has grown in popularity. Businesses often consider the cost per head (cost of promotion divided by the potential audience size) when selecting the most appropriate methods of promotion.

- *The product* - Certain products are suited to a particular type of promotion. For example, personal selling is highly suitable for insurance services and financial planning. But contrast, fashion magazines are relevant media for promoting beauty and cosmetics products. An advert for new movies or new model cars could be promoted on television and/or in specialist magazines.

- *The product life cycle* - The promotion methods used are dependent on the product's position in its life cycle. During the launch stage, there will be extensive promotion to get the product noticed and established in the market. During the decline stage, promotion may be withdrawn as the business focuses on marketing new products instead (see Chapter 27).

- *Legislation* - Rules and regulations can prevent certain products (such as tobacco or alcohol) from being promoted in certain media platforms such as on television. This means that alternative forms of promotion are required.

For most products, a combination of TTL methods is used as part of the organization's promotional strategy. Using an ATL or BTL promotional technique in isolation is unlikely to be effective. Different methods can be used to deliver a slightly different but reinforcing message about the product. When promoting a new movie, for example, the TTL promotional methods might include the use of:

- Television - to show trailers and teasers of the new movie.

- Radio - to raise awareness and excitement as well as to inform people about release dates.

- Outdoor advertising - using large outdoor posters (billboards) to promote the movie.

- Newspapers - to support the above methods and to show screening times at local cinemas.

- Internet - dedicated website to provide detailed information about the movie, the cast, director and producers, as well as other online platforms such as YouTube.

- Cinema - trailers of the new movie are shown at the cinema (point of sale).

However, TTL promotional strategies are more expensive to use than either ATL or BTL methods alone. For this reason, it is normally preferred by larger and more established businesses and financially secure organizations.

Key concept

For an organization of your choice, discuss the importance of **creativity** for above, below and through the line promotional techniques.

ATL Activity 29.2 (Thinking and Communication skills)

Suppose you work in the marketing department for a large pizza company, such as Pizza Hut or Domino's Pizza. Create a through the line promotional strategy to launch a nationwide campaign that showcases the business in order to gain market share in the highly competitive industry. Work in small groups of 3 or 4 people. Be prepared to present your recommendations to the rest of the class.

ATL Activity 29.3 (Thinking and Communication skills)

Suppose this time you work for a charitable organization such as Oxfam or the World Wide Fund for Nature. Your task is to create a through the line promotional campaign to build brand awareness and of encourage direct responses from supporters and donors. Again, be prepared to share your suggestions.

Exam tip !

The AIDA acronym can be used as a set of criteria for judging the success of a promotional campaign. It can be used to judge the extent to which the ATL, BTL or TTL promotional strategy draws the **attention** of the targeted audience, how it engages their **interest**, the intensity of the **desire** from potential customers, and ultimately the extent to which there is **action** taken to make a purchase.

Common mistake

Remember that it is incorrect to explain promotion as being synonymous with advertising. Indeed, advertising is a form of promotion. Promotion however, is far more than just advertising.

Theory of Knowledge (TOK)

In marketing, *what* is said and *how* it is said are of equal importance when trying to stand out from the competition. As key TOK concepts, what role do *culture* and *perspective* play in marketing messages?

Social media marketing as a promotional strategy (AO3)

Social media marketing (SMM) refers to the promotional practice of gaining online traffic through social media platforms such as Facebook, Twitter, LinkedIn, Instagram, YouTube and Google. SMM focuses on creating marketing *content* that attracts attention and encourages people to share this using their own methods via technology, such as social networks, web sites, blogs, instant messaging, and news feeds. SMM enables marketing messages and information about specific topics or products to be shared with targeted audiences, usually on a regular basis, such as weekly film reviews or monthly newsletters.



Figure 29.7 - SMM is being increasingly used by marketers as a platform for promotional activities

For example, film producers upload their movie trailers to platforms such as YouTube in order to target a wide and potentially global audience. Their goal is for online viewers to share the promotional video about the movie, thereby spreading

the message to their friends, families, and online followers of like-minded people.

Like WOM marketing, social media marketing is about spreading marketing messages for a particular product or brand from person to person but by using online technologies. SMM helps to build trust in a product or brand as the marketing message comes from a trusted, third-party source rather than from a commercial marketer. In addition, the potential reach of using SMM is much greater and faster than WOM marketing due to Internet technologies. SMM is also a highly cost-effective way to gain promotional exposure as the contents can be shared easily. For example, celebrities are often 'followed' on social media by their fans (and customers).

Social media marketing has become increasingly popular as the global number of Internet users continues to grow. Facebook (Meta Platforms), for example, has over two billion monthly active users so this provides a major promotional platform for many businesses around the world. There are over one billion active users on Instagram and another two billion active users of WhatsApp, both of which are also owned by Meta Platforms.

However, the key drawback is that businesses have no control over what is written or shared about their brand, products or services. This means it has little if any control about negative publicity that may appear online. Hackers also present a threat as they could deliberately spread false information about the business that can go viral, creating a public relations problem.

Social networking services such as Twitter, LinkedIn, Pinterest, Google+, Instagram and Facebook can be individual-centered or group-centered (as an online community). Individuals mainly use these platforms to build social relationships between people, often because they are friends or share things in common. They enable members to share information with other people in their online networks. For example, LinkedIn allows professionals and organizations to network online by sharing their professional profiles and career-related discussion forums. Hence, social networks provide targeted promotional opportunities for businesses.

Very few social network service providers charge for membership as they want to attract a large number of users, i.e. pricing their service would be counterproductive. Instead, these

CORE

Marketing

Question 29.5 - YouTube

YouTube, the world's largest Internet video sharing website, was launched at the start of 2006 by Steve Chen, Chad Hurley, and Jawed Karim, all in their late twenties at the time. Just ten months later, YouTube had grown so immensely throughout the world due to **social media marketing** that Google acquired the business for a $1.65 billion. In the same year, TIME Magazine named YouTube as Invention of the Year. Today, YouTube is the world's most visited website.

According to YouTube, there are over 2 billion active users on its platform, with an average of 30 million people using its website each day, and 100 hours of video content uploaded every minute. Google's goal is to use YouTube to earn money, mainly through **advertising**. It also strives to convince television, movie and music executives that YouTube is a huge revenue opportunity. YouTube ranks second most popular platform, after Facebook, for brands to post their online videos. However, only around 10% of small businesses have their own YouTube channel.

(a) Define the term *social media marketing*. *[2 marks]*

(b) Define the term *advertising*. *[2 marks]*

(c) Explain **two** benefits to businesses that choose to advertise on Internet video sharing websites such as YouTube. *[6 marks]*

providers such as Facebook and Google sell online advertising space on their platforms to businesses that want to reach out to the billions of people around the world who use social media marketing aimed at targeted audiences.

Other changing social media technologies include the increased use of *web banners* for promotion. Web banners embed adverts onto a website or online platform (such as YouTube) to attract and redirect Internet traffic to the advertiser's website. In many cases, the host charger the advertiser based on a *cost per click* (CPC) scheme. This also makes it easier for the business to monitor the results and effectiveness of its web banners. Businesses can also pay for a sponsored link on popular *search engines*, such as Google, Microsoft Bing and Yahoo! This appears at the top of a list of results when customers enter a particular word or phrase in the search engine. Businesses pay the host on a *pay per click* (PPC) basis, i.e. the advertiser only pays the host if their online advert is clicked by a user.

Key concept

Examine how developments in social media platforms could **change** an organization's marketing strategies.

Theory of Knowledge (TOK)

Promotion aims to change perceptions. "Perception is reality." Use real-life situations to determine the extent to which you think this statement is valid.

millions of dollars on a promotional campaign rather than using the money to directly benefit customers (such as lower prices) or employees (in the form of higher wages and benefits).

Unethical and controversial promotional strategies, including guerilla marketing, have prompted governments and pressure groups to introduce legislation and ethical codes of marketing practice. For example, consumer protection laws exist to prevent people from being deceived by misleading or dishonest promotions. In some countries, promotional activities are monitored and regulated by government agencies that deal with customer complaints. Financial penalties and other sanctions can be imposed on businesses that break the law or do not abide by ethical codes of practice.

Therefore, determining the optimal promotional budget and forecasting its probable impact on sales are by no means easy tasks. Nevertheless, effective promotion can certainly improve the financial health and sustainability of a business. Change in the form of innovations and technological advances have also provided new opportunities for publicity and promotion, through the use of social media marketing platforms.

The strategic implementation of any promotional strategy, be it ATL, BTL, TTL or SMM, is dependent on the creativity of marketers and the product in question. The promotional strategy for a specific product also changes over its product life cycle. Promotion then is a complex but vital component of any marketing strategy. Finally, it is important to remember that promotion must be used in relation to other aspects of the firm's marketing strategy; no amount of money spent on promotion will generate sustainable sales growth if the other elements of the marketing mix are ignored.

CORE

Promotion and the key concepts

Successful promotion relies on the creativity of marketers. Given that competitors are likely to have similar resources and know-how, the originality and creativeness of a promotional strategy can give a business the competitive edge that it seeks.

Although promotional activities are important, especially during the early stages of a product's life cycle (see Chapter 27), they can also be extremely expensive. This is also partly because it often takes many attempts for a promotional message to be noticed or acted upon, if at all. Critics argue that much of the expenditure on promotion is wasteful and could have been better spent on researching and developing better products. The ethical question is whether it is a justifiable strategy to spend

Key concept

Are anti-slimming adverts banned in your country? Should they be? What is the role of **ethics** in addressing this question?

Theory of Knowledge (TOK)

"All advertisements lie to some degree." To what extent do you agree with this statement?

Marketing

Business Management Toolkit

How do businesses adapt their promotional strategies to different cultures?

You may wish to refer to Chapter 54 (Hofstede's cultural dimension) prior to answering this question.

Common mistake

It seems that many students think of marketing as promotion or advertising. In fact, all three are different topics, albeit interrelated. Advertising is a form of promotion, but certainly not the only one, whilst promotion is just one element of the marketing mix.

Key concept

With reference to an organization of your choice, examine the role of **creativity** on its promotional strategy.

Key concept

With reference to an organization of your choice, examine the role of **ethics** on its various types of promotional strategies.

Key concept

Should **ethics** play a greater role in promotion or does this simply hinder **creativity**?

Business Management Toolkit

Using real-world examples, discuss the use of promotional strategies in relation to Porter's generic strategies (see Chapter 53).

REVIEW QUESTIONS

1. In the context of marketing, what is meant by promotion?
2. What are the key objectives of promotion?
3. What is advertising and how does this differ from promotion?
4. What is meant by above the line (ATL) promotion?
5. What are some examples of ATL promotion?
6. What is meant by below the line (BTL) promotion?
7. What are some examples of BTL promotion?
8. What is meant by through the line (TTL) promotion?
9. Why are an increasing number of businesses using TTL promotion?
10. What is social media marketing?

KEY TERMS

Above the line (ATL) promotion is any form of paid-for promotion through the mass media (such as television and radio) to reach a broad audience.

Advertising is a method of informative and/or persuasive promotion that is usually paid for. The aim of commercial advertising is to raise the level of demand for a firm's products.

Advertising clutter refers to the huge volume of advertisements that the public is bombarded with.

Below the line (BTL) promotion does not use paid-for mass media sources. Examples include the use of free samples (e.g. toiletries, food and drinks), discount vouchers (to entice customers to buy the product) and added-value promotions (e.g. special introductory deals).

Customer loyalty schemes are reward systems used to encourage customers to make repurchases, such as the use of price discounts or free gifts for members.

Direct mail is the use of postal correspondence for promoting an organization's goods and/or services.

Direct marketing refers to promotional activities that aim to sell a product straight to a customer rather than using an intermediary.

Impulse buying refers to unplanned or unintentional purchases due to the lure of eye-catching point of sales promotions.

Informative promotion aims to alert the market about a firm's products, especially new or updated goods and services.

Packaging is the art of presenting products in an advantageous way in order to improve sales.

Personal selling refers to promotional techniques that rely on sales representatives directly helping and persuading customers to buy, usually on a face-to-face basis.

Persuasive promotion aims to convince or encourage customers to make a purchase, to switch from rival products, and to enhance brand loyalty.

Point of sale is the promotion of goods in retail stores at the place where customers can purchase the goods, such as promotional displays at supermarket counters.

Promotion is a component of the marketing mix. It refers to the methods used to inform, persuade, and/or remind people about a firm's products and brands.

Public relations refers to marketing activities aimed at establishing and protecting the desired image of an organization. It is about getting positive media coverage, usually without directly paying for it.

Reminder promotion refers to techniques used to retain customer awareness of, and interest, in an established product.

Sales promotions are short-term incentives designed to stimulate interest in a product, such as the use of discount coupons, and prize draws.

Social media marketing (SMM) refers to the marketing practice of gaining Internet traffic through social media platform such as Facebook, Twitter, YouTube and Google.

Social networking refers to any online platform used to build social relationships between people, often because they share things in common. These are ideal sources for social media marketing.

Sponsorship is a promotional technique that involves funding, supporting or donating resources for an event or business venture in return for prominent publicity.

Telemarketing is a form of direct marketing that involves marketers making telephone calls to existing and potential customers as a form of promotional strategy.

Through the line (TTL) promotion refers to promotional strategies that involve both above and below the line methods, enabling customers to engage with the product or brand in multiple ways.

Trade shows are promotional events where firms exhibit and showcase their products for sale to potential customers.

Word-of-mouth (WOM) promotion refers to the spreading of promotional information from one person to another through verbal communications.

Topic 4: Marketing

CORE

Marketing

Chapter 30

Unit 4.5 - The seven Ps of the marketing mix (4) - Place

"When you have completed 95 percent of your journey, you are only halfway there."
- Japanese proverb

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Place (Distribution)

The importance of different types of distribution channels. AO3

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Place refers to the distribution of products, i.e., how products get from the producer to the consumer. For example, products could be available at large warehouses, at retail outlets, through agents or via the Internet. The Chartered Institute of Management defines place (or **distribution**) as "*Getting the right products to the right customers, at the right price, in the right place and at the right time.*"

An example is that customers can use banking services at a physical branch or online via Internet banking. Customers can also purchase clothes at a retail outlet, online via ecommerce or via mail order. Most people would buy bread from a supermarket or a local bakery.



Figure 30.1 - Place is about the distribution channels to get product to customers

Most products are not sold directly from the manufacturer to the final consumer (the end-user of the product). Coca-Cola, for example, does not sell its mass-produced products to the general public. This is partly because individual consumers would never purchase enough cans or bottles of cola directly

from the manufacturer to make it worthwhile for the producer. Instead, Coca-Cola's customers are the supermarkets and other large retailers that buy direct from the manufacturer and then split the bulk to sell to consumers in much smaller units.

The distribution decision requires management skills in persuading retailers to stock a firm's products. Retailers such as supermarkets have limited shelf and floor space so will only want to hold supplies of products that sell well. Cinemas have a limited number of screens so only purchase and show movies that will generate high sales revenues. Window displays in real estate agencies are very limited so the adverts they choose to display need to get quick sales. In essence, marketing managers need to convince distributors and other intermediaries to sell their products rather than rival products from competitors. Place in the marketing mix also addresses the geographical distribution of products (local, national or international).

Channels of distribution

The **channel of distribution** refers to the means used to get a product to the consumer (see Figures 30.2 to 30.4). **Intermediation** is the process used to facilitate this. **Intermediaries** are agents or businesses that act as a middle person in the channel of distribution between the manufacturer and consumers of a product.

The traditional channel of distribution consists of manufacturers, wholesalers and retailers. A long channel of distribution tends to raise prices for consumers as each intermediary will add a profit margin to the price. Furthermore, a longer channel of distribution lengthens the distribution process, meaning that such processes are not appropriate for perishable products, such as fresh milk, flowers, fruits and vegetables.

Marketing guru Dr. Philip Kotler, who popularised the 4Ps model of the marketing mix, referred to distributional channels as 'levels':

A **zero-level distribution channel** (also known as **direct distribution**) skips out any intermediaries, i.e., the producer sells directly to the consumer. Examples include the use of mail order, e-commerce and telesales. Direct distribution is common in the services industry. For example, customers can book their rooms at a hotel or make restaurant reservations without using an intermediary such as a travel agent.

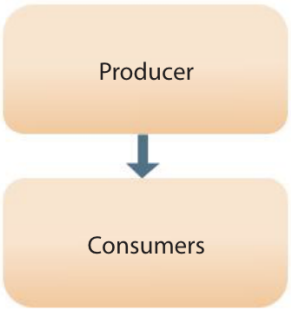

Figure 30.2 - The zero-channel distribution chain

A **one-level distribution channel** has one intermediary, such as retailers, agents or distributors being used to sell a manufacturer's products to consumers. For example, real estate agents are used to sell residential and commercial property on behalf of their clients. Book distributors are used to sell books on behalf of publishers.

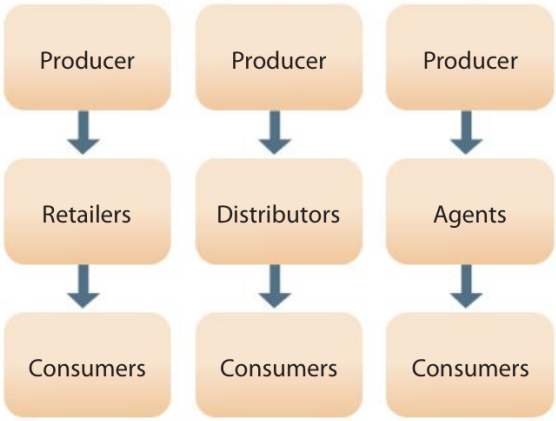

Figure 30.3 - The one-channel distribution chain

A **two-level distribution channel** uses two intermediaries, such as the use of wholesalers and retailers to get products to consumers. These are typically wholesalers and retailers

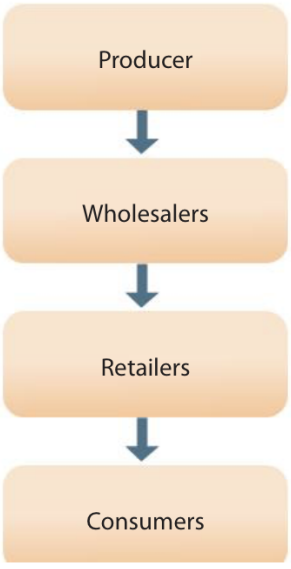

Figure 30.4 - The two-channel distribution chain

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The rest of this chapter looks at the main types of intermediaries in the channel of distribution. Common distribution channels include the following: (i) wholesalers, (ii) distributors and agents, (iii) retailers, (iv) speciality channels of distribution, which include e-commerce, vending machines and mail order.

Common mistake

Candidates often define the term channels of distribution as various methods of transportation. This is wrong. The channels of distribution are the intermediaries used to get products to the consumer, such as through wholesalers or distributors. It does not mean how products are transported (road, rail, sea or air).

(i) Wholesalers

Wholesalers are businesses that purchase large quantities of products from a manufacturer and then separate or 'break' the bulk-purchases into smaller units for resale, mainly to retailers. They act as the intermediary between producers and retailers. Examples of wholesalers include Costco, Sam's Club (owned by Walmart) and Makro. Using wholesalers has numerous benefits for producers and retailers:

- Wholesalers bear the costs of storage, thereby freeing up space for retailers, intermediaries and manufacturers.
- By breaking bulk, wholesalers sell smaller batches of products to retailers and intermediaries. This helps to eliminate their need to purchase large quantities directly from a manufacturer.
- There are lower transactions costs (such as invoicing and transportation) for the manufacturer, as wholesalers are the customers, not the countless smaller individual retailers and intermediaries.
- Frees up time for manufacturers to focus on production, as wholesalers deal with distribution issues and problems.

However, a key limitation of using wholesalers is that the producer takes a risk in passing on the responsibility of marketing its products. Wholesalers might not promote the manufacturer's products in a way that it desires, thereby ruining the producer's efforts. Also, some larger retailers (such as hypermarkets) do not use wholesalers, choosing instead to order directly from manufacturers. This cuts out the costs of using an intermediary to the detriment of the wholesaler.

Question 30.1 - Costco

Costco is the world's largest wholesale chain and the second largest retailer after Walmart. Its product range is huge, including items such as electronic appliances, beauty products, books, clothing, flowers, fresh fruits and vegetables, groceries, meats, pet foods, beverages, home and office furniture, outdoor furniture, office supplies, jewellery, sports equipment, toys, power tools, baby products, photo processing, plants and automobile accessories - all under one roof!

The company was founded in 1983 and has grown to more than 800 outlets throughout North and South America, Europe, and Asia Pacific. Costco boasts annual sales revenues in excess of $165 billion (that's more than $452 million in sales per day). The **wholesaler** focuses on offering products at low prices by selling in smaller bulks to boost sales volume. Its clients are mainly small businesses and families. Costco does not usually carry multiple **brands** of the same product, thus resulting in high volume sales for a single producer or supplier of the product.

Source: adapted from www.costco.com (Investor Relations)

(a) Define the term *wholesaler.* *[2 marks]*

(b) Define the term *brands.* *[2 marks]*

(c) Examine the benefits to both businesses and consumers in using wholesalers such as Costco. *[6 marks]*

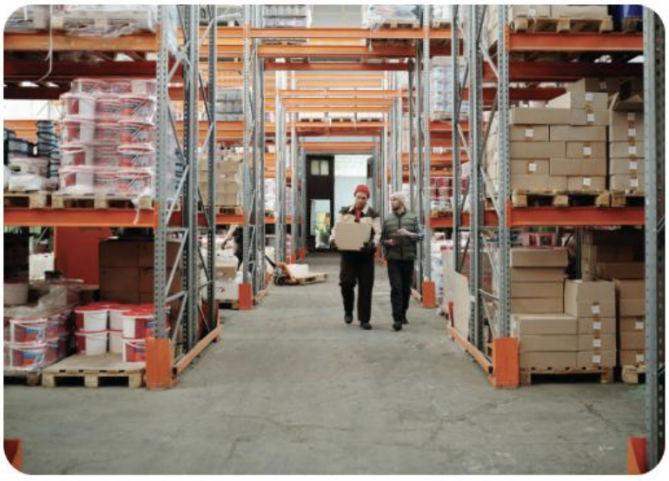

Figure 30.5 - Wholesalers are an important intermediary

(ii) Distributors and agents (brokers)

Distributors are independent and specialist businesses that trade in the products of only a few manufacturers. For example, car distributors typically sell the products of one manufacturer (such as Honda or BMW) to the consumer. Book distributors usually sell the books and other publications from a limited range of publishers. This helps to ensure the distributors know the products well, as they are representing the manufacturers in the distribution process of the marketing mix.

Agents (or **brokers**) are representatives and negotiators who act on behalf of buyers and vendors (sellers) of a product. They are not usually employed by the producer but are used as an intermediary to help sell the vendor's products. They are experts in their particular markets and charge commission for their services (a fee based on the level or percentage of the sales made). For instance, estate agents earn commission on each sale of real estate (property) made on behalf of their clients. Travel agents earn commission on the holidays and other leisure packages that they sell. Insurance brokers earn commission on the number and value of insurance policies that they succeed in selling to clients.

Agents usually offer a range of products for consumers to choose from, perhaps from several different suppliers. For example, insurance brokers often try to find the 'best deal' for their clients from the various insurance companies that they represent. Financial advisors also have a range of products that their clients can apply for, from various savings accounts to high-risk stock market investments from different corporate providers.

Agents tend to rely on personal selling techniques, such as door-to-door sales, telesales, trade fairs and exhibitions. Personal selling allows the sales agents to demonstrate how the product actually works and enables customers to ask questions relating to the product.



Figure 30.6 - Trade fairs and exhibitions can be used to promote and distribute products

(iii) Retailers

Retailers are the sellers of products to the final consumer. They are often referred to as 'shops' in everyday language. Retailers play an important role in the distribution of most products as retailers have the ability to reach large numbers of consumers, especially those that have a global reach. There are numerous types of retailers:

- **Independent retailers** are small local vendors, often owned by a sole proprietor. They usually sell a small range of products or are specialist outlets such as a hair salon.



Figure 30.7 - Independent retailers come in all shapes and sizes

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- **Convenience stores** are small retail businesses that stock a limited range of everyday fast-moving consumer goods, such as beverages, confectionery, groceries, over-the-counter medications, toiletries, newspapers and magazines and lottery tickets.

- **Multiple retailers** (or **chain stores**) are retailers that have numerous outlets, such as H&M (clothing), Starbucks (coffee) and Sunglass Hut (eyewear products). They can benefit from brand recognition and brand loyalty.

- **Supermarkets** are retailers that sell mainly foodstuffs and groceries. Examples include Tesco, Lidl, Aldi, Target and Walmart. Due to their large-scale operations, supermarkets tend to buy their produce and other products directly from manufacturers, thereby cutting out wholesalers.

- **Department stores** are retail outlets that sell a large range of products to the general public, such as furniture, jewellery, kitchen equipment, clothing, toys and cosmetics. It is quite common that franchisors or distributors run different parts of the store (hence the name 'department' stores). Unlike hypermarkets that are built on one floor (storey), department stores are built over several floors and are located in busy retail districts. Examples of department stores include Harrods (London), Macy's (New York City), Le Bon Marché (Paris) and Sogo (Tokyo).

- **Hypermarkets** (or **superstores**) are huge outlets that stock a broad range of products, such as foodstuffs and consumer durables. Due to their enormous size, they tend to be located in out-of-town areas where the space is available and the cost of land is more affordable. Examples of hypermarkets include Carrefour. Some of the larger supermarket chains, such as Tesco and Walmart, also operate superstores.



Figure 30.8 - Superstores sell a very large range of products

Most retailers rely on stocking well-known brands to attract customers. They base this decision on sales (or profits) per square metre. For example, if Coca-Cola products generate more sales or profits than rival brands per square metre of retail space, retailers will devote more shelf space to Coca-Cola goods. Similarly, prime space, such as the entrance to a store or other busy areas of an outlet tend to be reserved for the best-selling products or for the client that can offer the highest rental price in a department store.

Exam tip !

It is not always easy to distinguish between different types of retailers. For example, 7-Eleven is an example of a convenience store but is also a multiple retailer as it has operations across the world. The important thing is that you justify your reasoning when answering questions in the exam about importance of different channels of distribution.

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Question 30.2 - 7-Eleven

In November 2005, Japanese conglomerate Seven & I Holdings Co. completed the purchase of 7-Eleven Inc. (originally an American company, founded in 1927). Today, 7-Eleven is the world's largest chain of convenience stores, with over 71,800 outlets in many parts of the world. The **retailer** operates most of its stores as international franchises.

Source: www.7-eleven.com

(a) Define the term *retailer.* *[2 marks]*

(b) Outline the type of organization that 7-Eleven might be classified as. *[2 marks]*

(c) In the context of place in the marketing mix, examine the reasons for conglomerates such as Seven & I Holdings Co. operating international franchises. *[6 marks]*

(iv) Speciality channels of distribution

A speciality channel of distribution is any indirect way to distribute products that does not involve retailers, i.e., distribution without the use of intermediaries. Examples include e-commerce, vending machines and mail order. There are several advantages of speciality distribution channels:

- As there are no intermediaries, the business does not have to share its profits with other entities.
- Businesses can have direct control over their distribution, rather than relying on retailers, wholesalers and other intermediaries.
- The growing popularity of e-commerce means that customers are more willing to use the Internet as a distribution channel, especially with improved online payment security and the convenience of apps on mobile devices.
- Speciality distribution channels can reach potential customers who do not have easy access to retail outlets.

(a) E-commerce

E-commerce is trading via the Internet. The Internet has had a profound impact on marketing for businesses and is an increasingly suitable distribution channel for marketing many products. More and more businesses now use dedicated websites to provide product information and payment options to entice customers from around the world to buy their products, from the convenience of their home or office. It is also an effective way to reduce the costs and risks of international marketing (see Chapter 34).

However, not all products are suitable for online distribution. Customers buying cars, glasses (prescriptive spectacles) or jewellery will probably want to have direct contact with salespeople who can give a more personalised service. For most retailers, such as supermarkets and motor vehicle dealers, the Internet is not a replacement for traditional distribution activities but complements and supports the marketing strategies of these businesses.

Nevertheless, e-commerce continues to be an increasingly important distribution channel as more and more people have access to the Internet. The growth in the number of credit cards issued around the world, as well as users of mobile devices, has also propelled distributors and businesses that have an online presence.

(b) Vending machines

Vending machines are specialist machines that stock products for sale, such as cigarettes, drinks, snacks, toys and even hot meals. Due to their compact size, they can be placed almost anywhere, such as an office, recreation centre, shopping mall, public car park, school, hospital or airport. Modern vending machines allow customers to pay by a range of smartcard

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Question 30.3 - Sacha Cosmetics

Sacha Cosmetics, founded in 1979 in Trinidad and Tobago, is the world's first supplier of makeup products that are Haalal certified, with its products distributed in 23 countries. It has used the internet as an effective **channel of distribution** for propelling its business. The family-owned company has enjoyed the status of being the official cosmetics sponsor of the Miss Universe, Miss USA, Miss Panama, Miss Bahamas, and Miss Jamaica Pageants, which has helped it to become a global brand.

In 2015, Sacha Cosmetics was the winner of the inaugural Caribbean Exporter of the Year Awards. Furthermore, due to the company's **online presence**, American retail giant Walmart now carries full displays of the Trinidadian make-up line in many of its stores and on Amazon.

Source: www.sachacosmetics.com/en

(a) (i) Define the term *channel of distribution*. *[2 marks]*

(ii) Define the term *online presence*. *[2 marks]*

(b) Discuss the view that the Internet is an effective distribution channel for propelling businesses, such as Sacha Cosmetics. *[10 marks]*

methods, including credit cards and debit cards, thereby enhancing their convenience.

A key advantage of vending machines is that running costs and maintenance costs are minimal. For example, salespeople are not needed to sell the products. In addition, if the manufacturer owns the vending machines, it will stock only its own products which can help to reduce competition. However, vending machines can be prone to vandalism and mechanical failures, which will halt sales. Due to the low capacity of any single vending machine, only a small range of products can be sold via this distribution channel.



Figure 30.9 - Japan has more vending machines per capita than any other country

(c) Mail order

Mail order enables customers to order products via the postal system. Traditionally, customers use catalogues with product details and prices to place their orders. The convenience of being able to order from home helps to entice customers to purchase a firm's products. Businesses that have a customer database tend to use this channel of distribution. However, the cost of producing comprehensive and up-to-date catalogues is high, yet the shelf life is relatively short due to changing prices and new products being added to the market.

Mail order is often associated with **direct mail** - the use of unsolicited advertising materials sent to prospective clients via the mail. Detailed information aimed at different market segments can also be used in an attempt to boost sales. However, a major limitation of direct mail is that people tend to regard much of the correspondence as junk mail so there is a low response rate, i.e., people do not bother reading the mail. In addition, the information in a database often goes out of date. For example, when people move home, they do not necessarily inform the business of this, resulting in a large amount of direct mail being sent to the wrong (old) address.

In reality, most businesses use a range of channels to distribute their products. This is known as a **multi-channel distribution strategy.** For example, an airline company might use travel agencies, the Internet (e-commerce platforms) and airport outlets to sell its tickets. This enables the business to reach a wider range of customers, located in different areas and in different market segments.

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Question 30.4 - Dell and Walmart

Dell Inc. was founded in 1984 by Michael Dell, the company's founder and Chief Executive Officer. In 2007, the computer company announced plans to sell its personal computers through Walmart. Retail giant Walmart, renowned for its low prices, started selling Dell computers in its Walmart and Sam's Club stores in the USA, Canada and Puerto Rico.

The move was a major shift for Dell, which had traditionally sold its products directly to the consumer, cutting out the need for intermediaries. The company hoped the strategy would boost Dell's competitiveness and market share against rivals such as Lenovo and Hewlett-Packard. However, the deal did not prevent Walmart from selling other brands of laptops. In fact, Walmart decided in 2018 to launch its own brand of gaming laptops in order to gain market share in the lucrative computer gaming industry.

(a) Define the term *intermediaries.* *[2 marks]*

(b) Explain **two** advantages to Walmart in establishing a deal with *Dell Inc.* *[4 marks]*

(c) Evaluate Dell's decision to use intermediation to broaden its channel of distribution. *[10 marks]*

Factors affecting the choice of distribution channels

Place is concerned with how businesses ensure that their products reach both current and potential consumers. In order to compete in a sustainable and profitable way, strategic planning and analysis require marketing managers to deal with two key placement issues: the most suitable channels of distribution to use to get the firm's products to the consumer and how it will ensure that intermediaries stock the firm's products.

An efficient and cost-effective distribution strategy enables a business to make its products conveniently available to consumers. This raises the likelihood of customers purchasing the firm's products but requires managers to consider continual changes in the market. There are numerous factors that can affect this, including:

- *The product* - Perishable goods, such as fresh flowers and fresh meats, cannot be distributed through long chains of distribution. Hence, shorter distribution channels will be necessary. By contrast, fast-moving consumer goods need to be sold in large volumes, so the use of wholesalers and retailers would be appropriate. Innovations in technology and changing market conditions have meant that many products are sold directly through the Internet, such as books, music, movies, clothes, toys, theatre tickets and bookings for overseas holidays.

- *The market* - Local niche markets can be catered for by a supplier without the use of intermediaries. By contrast, large and dispersed markets usually require the use of intermediaries as part of the channels of distribution. For example, supermarkets rely on logistics and distribution companies for their own operational efficiency.



Figure 30.10 - Retailers rely on efficient delivery and transportation services

- *Time* - Whilst e-commerce can be a convenient channel of distribution, there is a time lag between customers paying for a product and receiving it. Hence, this method is unsuitable for buying items that require urgent delivery. Instead, the most direct channel of distribution would be more suitable.

- *Legal constraints* - Government rules and regulations can prohibit the distribution of certain products. For example, restaurants need special licenses to sell alcohol on their premises. Macau is renowned for being a casino magnet as numerous neighbouring places including Hong Kong and Malaysia have strict gambling laws. Hence, legal dimensions affect the distribution decision.

- *Cost and benefits* - Direct selling, without the use of intermediaries, reduces the costs of distribution. However, retailers and distributors may have better access to customers, especially in foreign markets where local knowledge of cultural norms can be an advantage. Hence, businesses need to weigh up the costs and benefits of using intermediaries. They also need to consider the relative merits of different transportation methods (road, rail, air or sea) as part of their distribution strategy.

For some businesses, such as Heinz and Coca-Cola, the distribution strategy focuses on maximising the number of outlets that sell their products as this helps to increase sales and profits. A straightforward but relatively expensive way to ensure that retailers stock a firm's products is to open its own retail store, an approach used by Nike and Adidas. Alternatively, firms can use franchise agreements (see Chapter 5) to allow other certified firms and people to run the stores under the name of the business. However, the marketers at other businesses, such as Tiffany & Co. and Rolls Royce, do not aim to have their products distributed in the same way; to do so would remove the exclusivity of their products and brands. Hence, a distribution channel strategy that works for one firm for a particular product does not necessarily work for others.

Place and the key concepts

Place (distribution) is a vital element of the marketing mix in order to get a good or service from the producer to the consumer in cost-effective ways. It is not sustainable or profitable for a business to manufacture a product that consumers need or want but then fails to distribute these to where customers want to purchase it. This is why textbook publishers use agents and distributors located in different regions of the world to get their books to schools, teachers, librarians and students.

Creativity and innovation play a crucial role in ensuring that retailers have the incentive to stock the products and brands of the producer. This can include creating products with a unique or distinctive selling point or products that are truly appealing to the market.

Changes in lifestyles have also influenced distribution strategies. For example, the growing use of digital and mobile technologies has created many business opportunities. They offer customers the option of using downloadable apps for distributing video games, music, movies, travel, taxi services and many other products.

The globalization of markets and increase in international trade have been fuelled by the rising number of businesses that sell their products in overseas markets via export markets and e-commerce. However, an export strategy presents further complications to a firm's distribution strategy due to various external constraints, such as:

- Fluctuating exchanges rates - The changing nature of exchange rates can make products cheaper (in which case export sales are likely to rise) but can also lead to higher export prices (in which case, demand will most probably fall). This creates uncertainty for businesses distributing their products in foreign markets.

- Cultural differences - Diversity in cultural norms might mean that some products are not suited to certain regions or countries, such as pork products in Muslim countries. Similarly, language barriers could exist. These constraints can cause communication problems with overseas intermediaries and customers. Hence, marketers need to consider cultural and ethical dimensions of the distribution strategies.

- Government intervention - Overseas governments may place trade barriers and legal constraints on exported products (see Box 34.1). Businesses also need to be aware of the changes to government rules and regulations that take place from time to time. For example, Great Britain's exit from the European Union (Brexit) in 2020 caused huge confusion for British businesses dealing with additional bureaucracy to get their products exported to the EU. Government interventionist measures make it more difficult and/or more costly to distribute the product.



Figure 30.11 - Brexit has created additional challenges for UK firms exporting goods to the EU

The path from producer to consumer normally involves more than one intermediary or organization, although cutting out parts of the distribution process has become increasingly popular in order to cut costs and raise profit margins. For example, insurance companies often sell directly to consumers rather than through brokers. New technologies have supported the shortening of the distribution chain and encouraged firms to sell directly to the consumer. Reducing costs in this way also enables firms to lower prices. Hence, changes in distribution strategies can help to improve the economic sustainability and survival of a business.

Therefore, change, ethics, sustainability and creativity all play a role in the need for an integrated and strategic distribution strategy. For example, to maintain market share, large supermarkets can no longer simply rely on customers revisiting their retail outlets. The largest supermarket chains have exploited Internet technologies as a channel of distribution and have seen their costs fall significantly as more customers choose to shop online. The use of self-checkout devices in supermarkets has also created additional choice for customers whilst enabling businesses to cut costs even further. Changing lifestyles have also led to supermarkets to adopt longer opening hours and additional delivery services to attract and retain customers. This has made distribution and logistics increasingly important for supermarkets and other retailers.

Theory of Knowledge (TOK)

Are the notions of reasoning and emotion mutually exclusive when marketing goods and services to customers?

Key concept

With reference to an organization of your choice, examine how **change** and **sustainability** have influenced its distribution strategy.

Theory of Knowledge (TOK)

How can we know which element of the marketing mix best describes the use of the Internet for selling goods and services?

How does the Internet change our knowledge and understanding of the traditional marketing mix for business organizations?

Business Management Toolkit

Discuss why a detailed and comprehensive business plan (see Chapter 48) is likely to include all elements of the marketing mix.

REVIEW QUESTIONS

1. What is meant by place (distribution) in the marketing mix?
2. What are distribution channels?
3. What are intermediaries?
4. What role do intermediaries have in the distribution of goods and services?
5. What are the different levels of distribution channels?
6. How do wholesalers differ from retailers?
7. What are agents (also known as distributors and brokers)?
8. What are speciality channels of distribution?
9. What is a multi-channel distribution strategy?
10. What are the main factors that affect the overall choice of distribution channels?

KEY TERMS

Agents (or **brokers**) are representatives and negotiators who help to sell a vendor's products, such as real estate agents or insurance brokers.

Channels of distribution are the ways that a product gets from the manufacturer to the consumer, such as wholesalers, agents, retailers, e-commerce or vending machines.

Intermediaries are agents or other businesses (distributors) that act as a middle person in the distribution channel.

Intermediation is the process of using intermediaries in the distribution channel between the manufacturer and consumers of a product.

Mail order is a speciality channel of distribution that enables customers to order products via the postal system.

A **multi-channel distribution strategy** refers to the use of a range of channels to distribute a firm's products.

A **one-level distribution channel** has one intermediary, such as retailers, agents or distributors being used to sell a manufacturer's products to consumers.

Place (or **distribution**) refers to the distribution of products, i.e., how products get from the producer to the consumer. It is the process of getting the right products to the right customers at the right time and place in the most cost-effective way

Retailers are the sellers of products to consumers in outlets (or 'shops').

Speciality channels of distribution refer to any indirect way to distribute products that does not involve retailers, such as e-commerce, vending machines and mail order.

A **two-level distribution channel** uses two intermediaries, such as the use of wholesalers and retailers to get products to consumers.

Wholesalers are businesses that buy large quantities of a product from a manufacturer and then 'break' the bulk into smaller units for resale, mainly to retailers.

A **zero-level distribution channel** (also known as **direct distribution**) leaves out any intermediaries, i.e., the producer sells directly to the consumer.

Chapter 31

Unit 4.5 - The seven Ps of the marketing mix (5) - People

"Customers do not come first. Employees come first. If you take care of your employees, they will take care of the customers."
- Sir Richard Branson, Founder of the Virgin Group

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The marketing of services

A **service** is an intangible product such as a bus ride, a visit to the museum, a trip to the theatre or a haircut. Unlike with physical goods, consumers of services do not actually take anything away with them after payment is made, i.e., there is no ownership of the product. **Goods** are physical or tangible products, such as smartphones, toys, books and clothes. By contrast, services are perishable as they cannot be kept. Services are heterogeneous, meaning that customers get a different experience each time and, unlike mass market goods, the quality is therefore varied. Businesses can also provide services to other organizations, such as transportation (freight), insurance, accounting, legal, consultancy, security and distribution services.

Customers pay for services to fulfill their wants and needs, such as to gain specialist advice or professional support, such as banking, counseling and tutoring services. Product differentiation is therefore important for the marketing of services. For example, commercial banks offer a range of different services such as savings accounts, overdrafts and mortgages. They use marketing tools to entice customers to use these different services. However, in addition to the traditional marketing mix for physical goods (price, product, promotion and place), the marketing of services includes three additional elements: people, processes and physical evidence. Together, these form the **7 Ps model** in the marketing mix of services, first suggested by Bernard Booms and Mary Bitner in 1981.



Figure 31.1 - The 7 Ps of the marketing mix for services

Theory of Knowledge (TOK)

Is there really a clear distinction between a good and a service? For example, a service is provided in a restaurant where there is consumption of goods. The purchase of a new car or home cannot happen without the service element. Are there any examples of 'pure' goods and 'pure' services?



Figure 31.2 - Appearances matter in the marketing of services

People

The importance of employee–customer relationships in marketing a service and cultural variation in these relationships. AO3

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People are the employees who interact with customers, thereby delivering the service to customers. The provision of services relies on the input and commitment of willing and able employees. For example, IB World Schools require suitably qualified and trained teachers who are passionate about their subjects to deliver engaging and purposeful lessons to students. Hotel staff are crucial in helping holiday makers enjoy their vacations. Flight attendants are vital in making a journey a pleasant experience for travellers. It is therefore important for service-orientated businesses to build good relationships and trust with their customers.

The reputation of a business largely depends on the training, motivation and communication skills of employees. The effectiveness of people in marketing or delivering a service can be observed or measured in a number of ways:

- *Appearance and body language* - Customers create an image of the organization in their minds based on the physical appearance as well as the body language of employees. For example, uniforms and formal business attire are worn in many occupations to portray a more professional look. For instance, newsreaders on television dress conservatively to portray a conventional and serious image. McDonald's operates a 'Smiles are free' policy to ensure that their customers are greeted and served with a friendly welcoming smile.
- *Aptitudes and attitudes* - Managers will be interested in measuring the capabilities and conduct of their employees, such as whether staff have sufficient product knowledge, whether they are proactive (meaning that they are attentive to the needs of their clients) and whether they are caring, courteous and confident. If the answers to these questions are positive, then it is highly likely that customers will be happy with the service being delivered. This can have profound effects on the business through positive word of mouth and referral marketing.
- *Feedback* - Comments made by various stakeholder groups can also provide useful information regarding the effectiveness of employees in delivering good customer service. Methods such as 'Employee of the month', suggestion schemes and records of customer complaints can also provide useful feedback to further improve the marketing of services and customer relations management.
- *Efficiency* - Employees who do not keep customers waiting and who do not make careless mistakes will help the business to gain a better reputation and improved corporate image. For example, restaurants, cinemas, theatres, concerts and airlines often have staff to assist customers to their seats. Staff training is therefore important to ensure employees are efficient in their jobs. By contrast, late deliveries and long waiting times (before customers are served) are signs of poor customer care and operational inefficiencies. Such inadequacies make it more difficult for the business to market its goods and services.



Figure 31.3 - Training is vital for the successful marketing of services

However, the behaviour of people is not consistent and there are numerous factors that affect their level of motivation (see Chapter 10), which can change from day to day. In addition, cultural variations have a direct impact on how people interact with customers. For example:

- Dominant cultures in India and Japan are averse to critical disagreements, so saying 'no' is regarded as being rather rude. Instead, any disagreements should be expressed with the use of diplomatic language.
- In some cultures, staring is considered to be rude and a lack of respect, so any interaction with customers may involve minimal eye contact to give customers space (or privacy). However, in other cultures the lack of eye contact is thought to be disrespectful and suggests that a person is not paying any attention.
- In the USA, it is commonly observed that supermarket staff help customers to pack their bags, whereas in Germany customers prefer to pack their own groceries.
- It is common in the UK for customer service personnel to be formal and conservative, whereas the French, Italian and Spanish are rather more relaxed in their approach.

Business Management Toolkit

Discuss how organizational culture (see Chapter 11) and Hofstede's cultural dimensions (see chapter 54) affect people in business organizations and hence the effects these have on the marketing mix.

Theory of Knowledge (TOK)

Does it matter that the motivation theories in the IB Business Management course (Taylor, Maslow, Herzberg, McClelland, Deci & Ryan, Adams and Vroom) are all from a Western perspective as the theorists are all from North America?

Case study 31.1 - Singapore Airlines

Singapore Airlines is the world's most awarded airline. The company's credentials include Best Corporate Social Responsibility, Best In-flight Service, Best Cabin Staff, Best First Class, Best Business Class, Best Economy Class and World's Best First Class. Singapore Airlines is well-known for its outstanding level of customer service, delivered from its flight crew. Its corporate slogan 'A Great Way To Fly' has been part of the airline's highly successful promotional campaigns. Its most prestigious award is winning the Best Airline for more than 20 consecutive years by Skytrax, the industry's consultancy company that oversees airline and airport review and rankings.

People and the key concepts

In modern societies, it is common for the majority of the country's workforce to be engaged in the services (or tertiary) sector (see Chapter 1). This heightens the importance of the marketing of services (with the extended 3Ps in the marketing mix) as part of any business strategy. Managing the provision of services can be more challenging than managing the marketing of physical goods. These challenges include:

- *Correcting mistakes* - It can be relatively easy to correct mistakes made during the manufacturing of physical goods, albeit costly perhaps. However, with the provision of services it can be very difficult to correct any mistakes made. A poor corporate image caused by substandard customer service might be irreversible.
- *Measuring productivity* - How can we measure the output of teachers, social care workers, volunteers, news presenters, doctors and actors? They all provide a service although it can be difficult to measure their productivity in the same way as measuring the output of workers who manufacture

physical products. As it is difficult to measure the output of intangible products, devising strategies to reward staff who are most productive can be very difficult.

- *People management* - The provision of services tends to be labour-intensive, which can be costly to an organization. Lawyers, architects and accountants, for example, are paid well for their skills and expertise. In service industries that require a large workforce, such as supermarkets and fast-food restaurants, it might be difficult for managers to ensure that all staff are consistent in their delivery of customer service. The lack of motivation from just one worker, for example, could be enough to tarnish the reputation of the entire business. Managing people in such professions requires effective leadership (see Chapter 9).

Therefore, the extended marketing mix for service can only be effective if a suitable culture is built within the organization. Human resource managers, for example, must pay attention to hiring the right people, training and developing people to deliver quality customer service, fostering a culture that encourages creativity to deliver unique service delivery and retaining the best people. Operations managers must ensure processes are convenient and efficient for customers. This, along with attention to physical evidence (see Chapter 33), gives the organization a competitive edge in a changing and competitive business world.

Technological change also creates challenges and opportunities for businesses. For example, innovations in Internet technologies, such as social media and customer review websites, mean that customers are more empowered than ever before. People who received substandard services, such as long queuing times or bad customer service, will quickly air and share their complaints via the Internet using social media platforms such as Twitter, Facebook, WhatsApp and a growing host of customer review apps.

CORE

Marketing

Key concept

With reference to an organization of your choice (such as a hotel, theme park or restaurant), examine how **change** and **ethics** have influenced people in the marketing mix of its services.

Business Management Toolkit

Discuss how cultural dimensions (see chapter 54) is important for understanding employee-customer relationships in the marketing of a service.

REVIEW QUESTIONS

1. What is meant by a service?
2. How do services differ from physical goods?
3. What is the 7Ps model of the marketing mix?
4. Why are people considered important for the marketing mix of services?
5. How might cultural differences affect the importance of employee-customer relationships?

KEY TERMS

Goods are physical or tangible products, such as smartphones, toys, books and clothes.

People are the employees who interact with customers, thereby delivering the service to customers.

A **service** is an intangible product supplied by a business, such as bus rides, library facilities, theatre shows, insurance policies and haircuts.

The **seven Ps model** refers to the marketing of services which includes three additional Ps (people, processes, and physical evidence) in addition the tradition 4 Ps in the marketing mix (product, price, promotion, and place).

Chapter 32

Unit 4.5 - The seven Ps of the marketing mix (6) - Processes

"We are what we do. Excellence, therefore, is not an act, but a habit."
- Aristotle (384BC - 322BC), Greek philosopher

Contents

4.5 The seven Ps of the marketing mix (6) - Processes	
SL/HL content	**Depth of teaching**
Processes The importance of delivery processes in marketing a service and changes in these processes	AO3

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Processes

Process refers to the way in which a service is provided or delivered. It can be difficult for a business to demonstrate the benefits of services to its customers. Insurance brokers, for example, often have a challenging task in convincing clients to buy life assurance policies as the process is complex. Businesses selling physical goods, however, tend to have a relatively easier task in demonstrating and convincing customers of the benefits.

Processes in the marketing of services include payment methods, queuing times, customer care, after-sales care and delivery services. The delivery process of purchasing a service is important as it can influence whether the customer makes future and repeat purchases based on the experience they have.

- **Payment methods** - Businesses may offer their customers the convenience of different methods of payment for the purchase of goods and services, including cash, cheque, bank transfer, hire purchase (see Chapter 15) or credit card. This makes the process of paying for a service more convenient for customers, but some businesses add a surcharge for the use of credit cards or bank transfers.



Figure 32.1 - Different payment methods add convenience for customers

- **Waiting time** - This refers to the average length of time it takes for customers to be served, such as how long they have to wait in a queue to get into a restaurant or the time between customers placing their online orders and them receiving the goods. There can be negative consequences if businesses do not manage the waiting times for their

customers, including customer complaints, disgruntled customers and a poorer corporate image. Many restaurants and fast-food chains offer a discount to customers if the product is delivered late. Similarly, diners might switch to another restaurant if they have to wait too long in a queue for a table. Such experiences can also lead to negative publicity through word-of-mouth and customer reviews on Internet rating websites.

- **Customer care** - This refers to the degree of attentiveness, care and politeness of staff towards their customers in the delivery of a good or service. The business can obtain constructive feedback on the quality of customer service from customer service satisfaction surveys, customer suggestion schemes or comment cards. Getting meaningful feedback and retaining customers are increasingly important, which is one reason why a growing number of businesses encourage customers to provide feedback by offering them discounts for future purchases upon receipt of their feedback comments.

- **After-sales care** - A business can gain a competitive edge if it provides after-sales services. These are services that are offered following the sale of the product, such as free installation, maintenance services, technical support and warranties (guarantees).

- **Delivery processes** (or **delivery services**) - This refers to the means of transporting goods from a source location, such as a restaurant, to a customer in another location, such as their home or place of work. Businesses can enhance the buying process of services (and goods) by providing various delivery options that are convenient for customers. Providing a delivery service, whether it is free of charge or not, can give a business a competitive edge. For example, in many parts of the world, McDonald's, Pizza Hut and KFC offer a free delivery service. Many other businesses use courier services, as third-party providers, such as Deliveroo and Uber Eats. Retailers that sell bulky items, such as washing machines or furniture, often offer a delivery service, which improves the buying process and convenience for customers.



Figure 32.2 - Delivery processes are part of the marketing mix for services

Processes are important as they can influence the overall quality of service experienced by customers. This can have a profound impact on customer loyalty. For example, if customers experience excellent delivery of customer care at a spa or hair salon, they are likely to tell their close friends and family, perhaps spreading the message on their social media platforms. This can provide the business with free but important viral marketing opportunities. This refers to organic or word-of-mouth marketing information about a good or service, which spreads exponentially using Internet and telecommunications technologies.

Question 32.1 - Aldi

German discount supermarket giant Aldi opened its first UK checkout-free supermarket in Greenwich in early 2022. Using advanced retail technologies, Aldi's Shop&Go store works by using an Aldi app on smartphones and cameras that track what customers pick off the shelves. Shoppers walk out of the supermarket without physically paying but are charged using digital technology.

Many customers like the convenience of a checkout-free supermarket, being able to process their purchases quickly and easily, noting the difference between traditional supermarkets and queues at the checkouts. Other customers are more apprehensive and somewhat confused about how all the technology works and are afraid of being accused of stealing if there are technological faults or unintentional human errors.

Critics have argued that the change also discriminates against elderly people and low-income families who may not own a smartphone or know how the technology works. Some customers complained about being unable to use the store as they do not have the storage space on their phones to download the Aldi app. Aldi became the third retailer to introduce checkout-free stores in the UK, after Amazon Fresh and Tesco.

(a) Define the term *process* in the context of the marketing mix. *[2 marks]*

(b) Explain **two** benefits and **one** drawback of Aldi's decision to introduce checkout-free stores in the UK. *[6 marks]*

Theory of Knowledge (TOK)

IKEA, the world's largest retailer of home furniture, sells most of its products in flat packs so that they are easy for customers to take home. IKEA claims that there is no such thing as free delivery, which is why it charges customers for each delivery. However, many businesses do offer free delivery as part of their process in service delivery. Can firms genuinely claim that they offer 'free' delivery?

Processes and the key concepts

Technological changes and the widespread adoption of smartphones and other mobile devices such as tablets have created many opportunities for businesses to improve their processes in the marketing mix. For example, many restaurants use mobile technologies for bookings and reservations, thereby improving the convenience for their customers. Such changes have incentivised businesses to be creative in their approach to processes in the marketing mix in order for them to remain competitive in a sustainable way.

Technological changes also create opportunities for businesses to be creative in their processes in order to engage with customers (see Question 32.1). For example, QR codes enable businesses to market their services by interacting with customers using their own mobile devices. Marketing strategies increasingly include the use of social networking, social media, blogs, microblogging and viral marketing.



Figure 32.3 - QR codes are used to promote goods and services

Key concept

Examine the importance of **creativity** in the processes of an organization's marketing mix.

Key concept

Examine how **change** has influenced the marketing mix for services provided by organization of your choice.

Business Management Toolkit

Discuss how the use of tools such as SWOT analysis (see Chapter 44) and STEEPLE analysis (see Chapter 46) can support a business in the development of a suitable marketing mix.

CORE

REVIEW QUESTIONS

1. What is meant by process in the marketing mix?
2. In the context of the marketing of services, what are processes?
3. Why are customer payment methods of importance in the marketing mix?
4. What is meant by after-sales care?
5. Why are delivery services important in the marketing mix?

KEY TERMS

After-sales care are services that are offered following the sale of the product, such as free installation, maintenance services, technical support and warranties.

Customer care refers to the degree of attentiveness, care and politeness of staff towards their customers in the delivery of a good or service.

Delivery processes (or delivery **services**) refer to the means of transporting goods from a source location to a customer in another location, such as their home or place of work.

Payment methods are the ways in which businesses offer their customers the convenience of different methods of payment for the purchase of goods and services, including cash, cheque, bank transfer and/or credit card.

Processes are the ways in which a service is provided or delivered, including payment systems, queuing times, after-sales care and delivery services.

Viral marketing refers to organic or word-of-mouth marketing information about a good or service, which spreads exponentially using Internet and telecommunications technologies.

Waiting time refers to the average length of time it takes for customers to be served.



Figure 32.3 - Sporting events create opportunities for marketers and sponsors

Chapter 33

Unit 4.5 - The seven Ps of the marketing mix (7) - Physical evidence

"More often than not, things and people are as they appear."
- Malcolm Forbes (1919 - 1990), Publisher of Forbes magazine

Contents

4.5 The seven Ps of the marketing mix (7) - Physical evidence	
SL/HL content	**Depth of teaching**
Physical evidence The importance of tangible physical evidence in marketing a service	AO3
Appropriate marketing mixes for particular products.	AO3

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CORE

Physical evidence (AO3)

Physical evidence refers to the tangible aspects of a service. In a 5-star hotel, for example, we might expect to see a clean lobby with nice décor and well-groomed hotel staff. The restaurants and hotel facilities should also be of high quality (such as hi-speed Wi-Fi, spas, gyms and swimming pools). The guest rooms in the hotel should be clean with fresh towels and bed linen. This all helps to make customers feel happy with the overall service provided by the hotel.

Similarly, students will be interested in the physical environment when choosing a university for higher education, rather than just the quality of the courses on offer. For example, students (the customers) will be interested in the quality of the student accommodation and learning environment (such as the lecture theatres, library, learning spaces on campus and other on-site facilities).



Figure 33.1 - The library at the University of Graz, Austria

Multinational retailers with stores across the world, such as McDonald's or Starbucks, focus on creating hygienic, homogeneous and hospitable environments. This helps to reassure people who like a sense of familiarity and tangible security, wherever they might be in the world.

Physical evidence is important for service businesses in most industries. Examples include hospitality and tourism (such as hotels and theme parks), large multinational companies (the physical building of their head office), cinemas (the size of the screens), football clubs (the stadium and its seating capacity), museums (the exhibits) and schools (facilities). The physical environment is designed to make customers feel welcome, safe and comfortable in order to ensure they have a memorable experience.

Many businesses use peripheral products in delivering their services. These are additional products as part of the firm's physical evidence in service delivery, such as drinks and fashion magazines offered to clients in a hair salon, used to enhance the overall service provided to customers.

Packaging is a vital aspect of physical evidence for many businesses. Packaging is the art of presenting products in an advantageous way to customers in order to improve sales. It is also a form of product differentiation. For example, most jewellers offer a special wrapping service. Packaging has a profound impact on customer perceptions of a product or brand. For example, imagine buying jewellery from Tiffany & Co., a handbag from Chanel or perfume from Louis Vuitton and receiving the contents in a bland plastic carrier bag! Customers perceive quality packaging with a quality product. Psychologists have also shown that people's moods are affected by things such as colours, textures and appearances. Businesses have therefore used packaging as a form of physical evidence to entice customers by using different colours, shapes, sizes and material.

CORE

Appropriate marketing mixes for particular products or businesses (AO3)

The physical environment and physical evidence of a service will have a direct impact on the level of customer satisfaction. It is particularly important for businesses that have face to face interactions with customers. For example, a coffee shop needs to look physically appealing and attractive to entice customers into the store.



Figure 33.2 - Coffee retailers need to consider all aspects of the marketing mix

However, physical evidence is only one of 7 components of the marketing mix. The other elements of the marketing mix also need careful consideration if the business is to succeed:

- *Product* - The coffee shop retailer will need to have a broad and appealing product range of drinks. This includes different types of coffees (see Box 33.1), teas, juices and other beverages. In addition, it will need to supply a range of food products to appeal to customers, such as sandwiches, snacks and bakery products.

Box 33.1 - Examples of coffee products

- Americano - Espresso coffee with hot water
- Cappuccino - Espresso with foamed milk
- Espresso (short black) - Highly concentrated coffee
- Iced Coffee - Espresso with milk and/or water, plus flavouring syrup
- Flat White - Like a cappuccino with chocolate powder but minus the foam
- Latte - Espresso with steamed milk
- Mocha - A coffee and hot chocolate hybrid, with steamed milk
- Vienna - Espresso and whipped cream

- *Price* - The coffee shop retailer also needs to consider appropriate pricing methods (see Chapter 28). For example, it may price its products at a level similar to competitors in the local area. Alternatively, it could use contribution analysis (see Chapter 57) to determine the most appropriate price for each good in its product portfolio. Prices need to be set appropriately to attract customers whilst earning profit for the business.

- *Promotion* - Even with the right products at the right prices, customers will not know about the coffee shop and what goods are on offer without effective promotion (see Chapter 29). This could include above the line promotion (such as advertising in local newspapers), below the line promotion (such as free tasters) and through the line promotion (suggest the use of social media marketing) in order to inform and persuade customers to purchase drinks and food products.

- *Place (distribution)* - The physical location of the coffee shop needs consideration as the location needs to be convenient for customers but must also fit within the firm's budget (see Chapter 21). Different types of distribution channels can be used to attract customers to purchase products from the coffee shop. Online sales of coffee products on the company's website (such as coffee beans, coffee mugs and reusable water bottles) can be part of the firm's placement strategy. Some coffee retailers also use online subscriptions, with direct delivery to the home or office address of customers, as well as third-party e-commerce platforms such as Amazon to reach customers.

- *People* - As a service provider, coffee retailers rely on their employees to deliver a first-rate service to their customers. The reputation of a business relies on the input and commitment as well as the willingness and ability of its workers. No matter how good the beverages are, how competitive the goods are priced at or how well they are promoted, without good customer service, people will not return to the store.

- *Processes* - This refers to the way in which a service is provided or delivered to customers. In the context of the coffee shop example, processes in the marketing of services include payment methods and average queuing times for customers. It may also include seating arrangements and table service for customers ordering food and drinks. Processes are important as they influence the overall quality of service experienced by customers.

ATL Activity (Research and Communication skills)

Devise an appropriate marketing mix (covering all 7 Ps) for a product or organization of your own choice. Present your findings to the rest of the class using appropriate methods of communication.

CORE

Question 33.1 - Wallington High School for Girls

Wallington High School for Girls (WHSG) is a selective grammar school for girls. The school was founded in 1888 and is located in Surrey, in the UK. Selection is based on an academic entrance exam. There are several other selective and private fee-paying schools in the proximity. Surrey has a reputation for having the best schools in the UK based on academic results.

Like all schools, WHSG is involved in the marketing of its service. Each year, the school's leadership team and its Board of Governors deliberately organize and oversee events to market the organization. These events include parents' information evenings, charity events, celebration evenings, music concerts and drama productions. WHSG has Engineering Status, which gives it extra funding from the government and it proudly markets this achievement. The school also communicates its outstanding examination results on its website (www.wallingtongirls.sutton.sch.uk) and in communications to all key stakeholder groups.

(a) Explain **two** reasons why marketing is important to organizations such as WHSG. *[4 marks]*

(b) Examine how people, processes and physical evidence are vital elements of the marketing mix for WHSG. *[6 marks]*

Physical evidence and the key concepts

Physical evidence is important to all businesses operating in service industries. The forces of competition and change create incentives for businesses to pay attention to the physical environment and physical evidence associated with their service provision. For example, traditional hotels have been negatively affected in recent times by competition from Airbnb as well as the prolonged global recession caused by the COVID-19 pandemic. These hotels compete on the grounds of physical evidence by providing value-added services such as spas, gyms, restaurants, retail stores, tour services and modern swimming pools. Guests are very likely to consider the physical environment before choosing between competing hotels. Hence, creative marketing strategies that focus on the hotel's physical evidence can help to give the business a competitive advantage.



Figure 33.3 - Premium hotels have outstanding facilities such as modern swimming pools

It is worth noting that the physical environment is also important in marketing an organization to existing and potential employees. People are more likely to be productive, motivated and loyal to organizations that consider the importance of the physical working environment. For example, Google's creative designs of its workspaces ensure that employees are never more than 100 metres away from where they can get complimentary food and drinks. Google employees also benefit from on-site access to wellbeing facilities such as fitness gyms.

In summary, all aspects of the marketing mix need to be considered in the context of the product and the changing needs and preferences of customers and other key stakeholder groups. Paying attention to physical evidence, as well as the other components of the market mix, can give the organization a competitive edge in an ever changing and more competitive business world.

Business Management Toolkit

With reference to physical evidence and the key concept of **sustainability**, discuss why it is important for businesses to consider circular business models (see Chapter 51).

Key concept

Discuss the role of **creativity** in improving physical evidence for a business organization of your choice.

Key concept

Discuss the importance of physical evidence for the **sustainability** of a business organization of your choice.

REVIEW QUESTIONS

1. What is meant by physical evidence?
2. Why is physical evidence considered important for the marketing mix of services?
3. What is packaging in the context of physical evidence?

KEY TERMS

Packaging, as a form of physical evidence, is the art of presenting products in an advantageous way in order to improve sales.

Physical evidence refers to the tangible aspects of a service, such as a luxury hotel with its nice décor, spas, gyms, and swimming pools.

Chapter 34

Unit 4.6 - International marketing (HL only)

HIGHER LEVEL

"Think like a wise man but communicate in the language of the people"
- William Butler Yeats (1865 - 1939), Irish poet and winner of the Nobel Prize in Literature, 1923

Contents

4.6 International marketing (HL only)	
HL content	Depth of teaching
The opportunities and threats posed by entering and operating internationally	AO3

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Opportunities and threats of international marketing

The opportunities and threats posed by entering and operating internationally. AO3

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International marketing is the marketing of a firm's goods and/or services in foreign countries. International marketing can be challenging for businesses because they need to deal with external factors and constraints such as differences in political systems, legislation, language and cultures. Hence, international marketing usually requires an amended marketing mix to suit local markets. A lack of understanding of different cultures can prove problematic for even large businesses. For example, Walmart, the world's largest retailer, had to sell its stores in Germany to local rival Metro when it discovered that its American practices (such as helping customers to pack their bags at the supermarket) were unsuccessful and did not suit the German culture.

Nevertheless, international marketing presents both opportunities and threats to businesses. **Opportunities** are external factors that create business prospects or openings for a firm's growth and development in international markets. By contrast, **threats** are external factors that create challenges and obstacles for businesses wanting to expand and operate in overseas markets.

The opportunities of entering and operating internationally (AO3)

- **Increased customer base** - The size of a market can be enlarged by marketing products to overseas buyers. This should lead to greater sales revenue and possibly higher market share for the business. For example, Rovio Entertainment, the creators of the Angry Birds franchise, generates over 95% of its sales revenues from outside Finland, its home country. Heineken, the Dutch brewery, exports its beer to 170 different countries. According to its website, Coca-Cola's products are sold in over 200 countries and territories worldwide, with consumers drinking more than 1.8 billion servings of the company's beverages each day.

- **Economies of scale** - By operating on a larger and international scale, a business is likely to benefit from cost savings known as economies of scale (see Chapter 5). These cost-reducing benefits of larger scale operations can enable growing businesses to gain higher profit margins and/or to

reduce their prices (thereby giving them a price advantage over their competitors). Businesses can benefit from lower production costs by operating in overseas markets, such as access to cheaper labour and raw material costs.



Figure 34.1- Many businesses have benefited from offshoring production to India

- **Increase brand recognition** - Having a standardized marketing strategy across the world (such as using identical packaging and advertising for global brands) not only reduces average costs of production but can also lead to greater international recognition of a brand. This can lead to improved brand loyalty and increased global sales revenues.

- **Spread risks** - By operating in various international markets, a business is less exposed to the risks in one particular country (such as a recession or changes in fashion and tastes). For example, German carmaker BMW relies on overseas markets for its sales growth. In 2020, China was the largest sales market for BMW, accounting for around 33.5% of BMW's sales (which include the Rolls-Royce and MINI brands). The USA was BMW's second largest market with 13.2% of the company's sales (around 1% higher than domestic sales in Germany).

- **Wider distribution channels** - Having a wider distribution channel (see Chapter 30) increases the potential number of foreign buyers. For example, Japanese car producers Honda, Toyota and Nissan all have manufacturing plants in France and the UK, enabling these producers to gain access to the huge markets in Europe markets. Developments in e-commerce have also been an effective way to reduce the costs and risks of international marketing whilst broadening distribution channels. Many online retailers, such as Amazon and eBay, have gained access to foreign markets without having to physically set up production facilities and retail stores.



Figure 34.2 - E-commerce enables businesses to access international markets

- **Extend the product life cycle** - A business might find that the domestic market for its product is saturated or in decline. By marketing the product overseas, the business can expand its life cycle to generate higher sales revenues. Many smartphone producers and car manufacturers use this strategy when selling older models of their products in low-income countries.

- **Gain more profit** - Ultimately, all the reasons above for international marketing can help to generate more profits for the business. Overseas markets provide a significantly larger source of revenue so can be financially lucrative. Gaining profit can also come about due to lower costs of operating overseas. BMW's manufacturing plant in Chennai (India's fourth largest city) helps the German producer to avoid a 60% import tax on its cars.

Case study 34.1 - Jaguar Land Rover



The Range Rover brand is owned by Tata Group

Jaguar Land Rover (JLR) is a luxury brand owned by Indian conglomerate Tata Group. Over 80% of JLR's sales are to overseas markets. Originally British brands, the US and China are the largest markets for Jaguar and Land Rover cars, as JLR continues to take advantage of the opportunities of international marketing.

The threats posed by entering and operating internationally (AO3)

The legal, political, social and economic issues surrounding international marketing can pose both opportunities and threats to businesses. Such threats can have detrimental impacts on the strategic operations of an organization as it operates in overseas markets.

(i) Legal issues

Entry into international markets can be a problem due to different legal systems. For example, cigarette advertising is still permissible in several European countries, but advertising tobacco products on television has been banned in the USA since 1971. Advertising in general is largely prohibited in Cuba and in São Paulo, Brazil, so even for large multinational companies this would present a major barrier to international marketing. Even the same law (such as packaging and labelling regulation on food products) may have different standards in different countries. This means it might be more difficult (and hence more expensive) to sell the same products in overseas markets.

Beyond legislation, governments can also set up other international trade barriers to protect their domestic industries (see Box 34.1), thereby creating a threat to businesses trying to enter and operate in overseas markets.

Intellectual property rights (see Units 17 and 42) must also be adhered to. This covers copyright, trademark and patent legislations, including matters such as brand names, slogans, inventions, creative works of art and processes already legally assigned to other businesses. Marketers need to take this legal factor into consideration when devising their international marketing campaigns. For example, Burger King was unable to use its global brand name in Australia as another business in Adelaide, South Australia had already trademarked the name.

Differences in consumer protection laws must also be observed by international marketers. Many countries have their own code of conduct on advertising and packaging information, for example, so these must be respected. The British Advertising Standards Authority, for instance, states that all adverts must be "decent, truthful and accurate". In most EU countries, there are legally binding controls over the use of advertisements aimed directly at children, such as in Sweden where it is illegal to advertise products on television to children under the age of twelve.

Box 34.1 - International trade barriers

- **Tariffs** - These are import taxes, which increase the price of imports (thereby supporting domestic firms) as well as helping to raise government revenues.
- **Quotas** - These are quantitative restrictions on imported goods, thus limiting the number of foreign products allowed to enter the country.
- **Embargoes** - These are outright bans on certain products entering a country due to major health and safety threats or political conflict, such as the US trade embargoes imposed on Cuba since 1962.
- **Administrative barriers** - These are bureaucratic obstacles such as safety regulations, licenses and employment visas (thereby making entry much more difficult).
- **Subsidies** - These are a form of financial assistance given by the domestic government to domestic businesses in order to reduce their costs of production (hence giving them a cost advantage over foreign competitors).

(ii) Political issues

The degree of political stability within a country can have a major impact on whether international marketers succeed in overseas markets. For example, trade protectionist measures (see Box 34.1) such as tariffs, quotas and subsidies for domestic businesses, create major obstacles for international marketing. Political and social unrest, which can sometimes spark violent protests, as well as corruption, will destabilize operational and strategic decisions for international marketers operating in these countries.

Businesses that market their products overseas need to consider the different political systems abroad. Countries that have a stable political climate tend to be less risky and more receptive to foreign businesses selling products in their territory. According to the World Bank's annual "Doing Business" reports, there are few political barriers for conducting business in New Zealand, Singapore and Denmark. By contrast, there are huge political hurdles to deal with if businesses wish to market their products in other countries such as Afghanistan, Cuba or North Korea.

HIGHER LEVEL



Figure 34.3 - Singapore is consistently ranked by the World Bank as the best place to do business

(iii) Social and demographic issues

Different socio-economic and demographic conditions mean that businesses may need to reconsider aspects of their international marketing. For example, Samsung's product range and prices for its smartphones will differ when marketing to customers in low-income countries compared with the products and prices for its smartphones targeted at customers in high-income nations. With growing prosperity and income in some parts of the world, international marketers can target different customers with different products. In 2006, supercar manufacturer Lamborghini opened its first showrooms in China and India due to the phenomenal economic growth rates in both these countries.

Demographics is the study of population trends and it is important for marketers to recognise that demographic changes will have direct impacts on international marketing. For example, Monaco and Japan have the world's oldest populations (as measured by the median average age of the population) so marketers take a different approach to pricing, product, place and promotion when targeting these countries than if they were marketing to nations with younger populations such as Kenya, Colombia or Vietnam. Similarly, cultural norms of the population need to be considered. For example, frozen food products such as microwave-ready meals are popular in the US and many European countries but are not in most Southeast Asian nations.

Case study 34.2 - McDonald's, Vietnam

In 2014, McDonald's opened its first restaurant in Vietnam, owned by Henry Nguyen, son-in-law of Vietnam's communist-ruled leader. International marketing has led to heavy foreign direct investment (FDI) in Vietnam aimed at the country's young population buying global consumer brands. Four decades after the Vietnam War with America ended, McDonald's followed US rivals Burger King, KFC and coffee shop chain Starbucks into Vietnam.

Language is another issue that needs to be considered. Overseas customers in Japan (expatriates and tourists) are not very well catered for as only about 1% of the population are foreigners. By contrast, in highly multicultural societies such as Malaysia, marketing caters for a much wider audience with the some adverts expressed in Malay, Chinese and Indian languages.



Figure 34.4 - Malaysia is a highly multi-cultural country

Theory of Knowledge (TOK)

Discuss the role of language in marketing a product in international markets.

Organizations also need to consider societal norms regarding **business etiquette**. This refers to the mannerisms and customs by which business is conducted in different parts of the world. Having local knowledge and a good level of understanding of differences in business etiquette can help international marketers to succeed in overseas markets.

ATL Activity 34.1 (Research and Communication skills)

Investigate examples of business etiquette for a country of your choice. Be prepared to explain your findings to the rest of the class.

A final social factor the international marketers need to consider is the potential threat of pressure groups. Pressure groups (see chapter 4) are concerned with the impacts of business activity on society, so these organisations can also create problems for marketers hoping to gain a foothold in foreign markets. For example, People for the Ethical Treatment of Animals (PETA), the world's largest animal rights group, has caused many problems for companies, such as McDonald's, KFC and Procter & Gamble, trying to enter and operate in overseas markets.

ATL Activity 34.2 (Research and Thinking skills)

McDonald's is sensitive to the needs of customers in markets where pork and beef products are not consumed, due to religious reasons.

For an organization of your choice, research other examples where culture and religious beliefs directly impact on international marketing.

Theory of Knowledge (TOK)

To what extent does cultural tourism respect local cultures and promote societal norms and values?



Tourists in Morocco

(iv) Economic issues

A key argument for more and freer international trade is that it enables people to have a greater choice of products at more competitive prices. International trade also allows citizens to have access to products that would otherwise be unavailable in their own country because domestic producers cannot supply certain products in a cost-effective manner, such as tropical fruits being grown in cold countries. These arguments can present major international marketing opportunities, especially for large businesses. However, the main threat in this case is the high costs of overseas investment, which can harm the cash flow and profits of the business in the short term.

Question 34.1 - The Ford Focus

The Ford Motor Company launched its Pinto model in 1971. This was a compact sized family car that came in several different engine sizes with slight variations such as 2-door and 4-door versions. The Pinto brand didn't work well in Brazil as 'pinto' is slang for a derogatory word. Ford eventually became aware of this and renamed the car Corcel, which means horse. In America, the Pinto was named Mercury Bobcat. By 1981, the Pinto name had been replaced by Escort. Then in 1998, the Escort brand was finally replaced by a single global name: the Focus.



The Ford Focus

(a) Explain **two** benefits to Ford Motor Company in using 'Focus' as a single brand name on an international level. *[4 marks]*

(b) Examine whether there are any justifications for the Ford Motor Company using different brand names in marketing its product in different parts of the world. *[6 marks]*

HIGHER LEVEL

Question 34.2 - Tesco

Tesco is the UK's largest retailer, with annual sales in excess of £65 billion ($92bn). Although the company has entered several international markets such as France, Poland and China, the vast majority of its sales still come from within the UK. Tesco set up its first supermarket in the USA in 2007, although the American market remained rather untouched with Walmart being the dominant market leader. By 2013, Tesco had pulled out of the USA. However, the company has continued to grow with operations in 11 other countries.

(a) Define the term *market leader*. *[2 marks]*

(b) Explain **two** reasons why customers in overseas markets might benefit from the operations of Tesco in their country. *[4 marks]*

(c) Evaluate the opportunities and threats to Tesco of their overseas expansion plans. *[10 marks]*

However, international marketing of products also increases the degree of competition in the marketplace. Transportation costs, exchange rate fluctuations, interest rates and communication costs are further economic issues that need to be considered when marketing products overseas.

Furthermore, marketers need to consider the stability of the economy as this directly affects the degree of success of international marketing. During a global financial crisis, for example, most businesses will struggle irrespective of their marketing strategies, experience and budgets.

Case study 34.3

In 2013, Starbucks joined forces with Tata Group (which owns Jaguar and Land Rover) to set up coffee shops in India. The partnership created 34 stores within the first year, although Café Coffee Day, India's largest shop chain, has over 1,550 outlets, serving more than 1.8 billion cups of coffee each year.



ATL Activity 34.3 (Research skills)

Investigate the importance of business ethics and business etiquette for international marketers in a country of your choice.

International marketing and the key concepts

Changes in the global business environment as well as online technologies mean that businesses that are able to adopt international marketing strategies can gain from being able to market their products throughout the world. After all, having to change products to suit local preferences or cultures can be costly. The dilemma facing marketing managers is trying to gain economies of scale by using a single international marketing strategy yet still cater for local or regional preferences and tastes. While it is possible for large multinational companies such as Coca-Cola and McDonald's to make the odd costly mistake, smaller businesses cannot afford to do so. In any case, firms need to ensure that their international marketing strategies are carefully researched and planned because failure overseas can be disastrous to the organization as a whole.

In today's ever-globalized world, ethical principles have extended across cultures and nationalities. Nevertheless, cultural differences are still widespread so what is ethically acceptable in one country may not be in others. For example, the European Union bans the use of pester power marketing

(aimed specifically at young children), yet the use of child labour is socially acceptable in other cultures. Businesses have to be sensitive to the beliefs and ethical values of local and global communities; exporting cultural norms and values is not always an ethical practice. It is therefore important for international marketers to understand the countries and cultures in which they operate, such as societal norms and values.

Globalization and international marketing strategies have their critics. **Globalization** is the integration and interdependence of the world's economies, resulting in cultures and tastes converging at an accelerating pace. Pressure groups and the media have provided another perspective on the negative impacts of globalization and international marketing. For instance, in his book '*Fast Food Nation*', Eric Schlosser discusses how international marketing of the fast-food industry has led to increased obesity in China and Japan. The documentary-movie '*Supersize Me*' and the film adaptation of Schlosser's book have highlighted some of the ethical issues that arise from the marketing of American fast-food culture throughout the world.

As the world continues to globalize at an increasing pace, an important element of success for marketers with an international outlook is the appreciation and respect for cultural differences and cultural diversity. It is useful to remember the proverb "When in Rome, do as the Romans do", which advises people to adapt to different cultures and etiquette when visiting other countries. Therefore, many businesses choose to use joint ventures and strategic alliances with local partners, which has proven to be highly practical for international marketers. An understanding and awareness of international business etiquette can ultimately give an organization a competitive advantage in an ever-competitive and changing business world.

To be a sustainable business, international marketing strategies need to evolve in response to changing customer preferences across the world. In an ever changing and globalized business world, with the growing presence of foreign competitors, businesses are finding it increasingly important to consider the opportunities and threats of international marketing.

ATL Activity 34.4 (Research skills)

Despite the uniformity and opportunities brought by globalization and international marketing strategies, countries still have their national identities through language, culture, and other unique characteristics. Hence, marketing strategies are likely to need businesses to adapt products and services to meet the varying needs of their international clients.

With reference to an organization of your choice, examine how international marketing strategies have catered for local needs of customers in overseas markets.

Question 34.3 - Colgate-Palmolive

Colgate-Palmolive is an American multinational company that produces personal hygiene products (such as toothpaste and soaps) and cleaning products (such as detergents), as well as veterinary products. The company was founded in 1806 and has a global marketing presence with operations in over 200 countries and territories. The company's growth has been driven by strong sales revenue of its brands of toothpastes, soaps, and other household products that are recognised across the world. Introduced in 1873, Colgate is the world's top selling brand of toothpaste.

Source: adapted from www.colgatepalmolive.com/en-us



(a) Define the term *sales revenue.* *[2 marks]*

(b) Describe the type of product that Colgate toothpaste might be classified as. *[2 marks]*

(c) Discuss the extent to which the brand name of a product, such as Colgate or Palmolive, is important for successful international marketing. *[10 marks]*

HIGHER LEVEL

Question 34.4 - McDonald's

McDonald's, the world's largest fast-food chain, has global sales revenue in excess of $22bn. With over 38,000 restaurants worldwide and a workforce of over 1.9 million people in over 100 countries, McDonald's are experts at international marketing. For example, to revamp its global business, the company added salads, fruits and other healthy options to its traditional menu of burgers and French fries. The company marketed this change to its product portfolio by publicising nutritional facts on its food products.

Critics have argued that McDonald's foods and drinks remain unhealthy and high in calories. McDonald's marketing strategies aimed at children, such as their trademark Happy Meals™, have been attacked due to soaring obesity levels amongst children. Equal opportunities groups have also complained that Happy Meal™ toys cater predominantly for boys.

(a) Define the term *international marketing*. *[2 marks]*

(b) Outline **one** possible problem created by the critics of McDonald's for the business. *[2 marks]*

(c) Examine **two** reasons for the growth in the global sales revenue of McDonald's. *[6 marks]*

(d) Discuss the extent to which international marketing strategies have made fast-food a globalized industry. *[10 marks]*

Business Management Toolkit

Investigate the role of cultural dimensions and cultural differences in international marketing. You may want to read Chapter 54 before tackling this task.

Key concept

With reference to an organization of your choice, discuss how **creativity** and **ethics** have influenced its international marketing strategies.

Key concept

For an organization of your choice, examine how international marketing strategies may evolve in response to a **change** in customer preferences.

REVIEW QUESTIONS

1. What is meant by international marketing?
2. What are the main advantages (opportunities) of international marketing to businesses?
3. What are the main threats posed by entry into international markets?
4. How do social and demographic issues affect international marketing?
5. What is meant by business etiquette and how does it influence international marketing?

KEY TERMS

Business etiquette refers to the mannerism and customs (traditions) by which business is conducted in different countries.

Demographics is the study of population trends in relation to its impacts on international marketing.

Globalization is the integration and interdependence of the world's economies, resulting in cultures and tastes converging at an accelerating pace.

International marketing is the marketing of an organization's goods and services in overseas countries.



Figure 34.5 - International marketing is about marketing to overseas customers

Opportunities are external factors that create business prospects or openings for a firm's growth and development in international markets.

Threats are external factors that create challenges and obstacles for businesses wanting to expand and operate in overseas markets.

HIGHER LEVEL

Chapter 35

Unit 5.1 - Introduction to operations management

"If it can't be reduced, reused, repaired, rebuilt, refurbished, refinished, resold, recycled or composted, then it should be restricted, redesigned or removed from production."
- Pete Seeger (1919 - 2014), American folk singer and social activist

Contents

5.1 Introduction to operations management	
SL/HL content	Depth of teaching
The role of operations management	AO2

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Operations management

The role of operations management

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The role of operations management can be explained by its links with other functional areas of a business organization. **Operations management** (often referred to as **production**), is concerned with providing the right goods and services in the right quantities and at the right quality in a cost-effective and timely manner. Operations management impacts all functional areas of a business. For example, a change in production methods (see Chapter 36) can be caused by numerous reasons, including attempts to achieve greater efficiency (see Chapter 37), the use of just in time production techniques (see Chapter 40) or simply because of the growth of the business (see Chapter 5). These changes, whatever the reasons, have a direct impact on the other functional areas of the organization.



Figure 35.1 - Operations management is about the production of goods and/or services

Marketing implications

The operations method (or production method) used to provide a good or service will affect both the quality and the individuality of the product. The output of an exclusive product means that it can be marketed at a premium price due to its uniqueness and high quality.

Packaging, physical evidence and people also play an important part in the overall marketing mix. For example, customers of Bugatti supercars are invited to have a meeting with a sales manager to discuss their personal requirements for the vehicle. By contrast, mass produced goods, such as Coca-Cola or Heinz Baked Beans, are standardized (see Chapter 36). There are likely to be plenty of substitutes available on the market for these products, so prices are much more competitive.

Promotional strategies are also more impersonal and aggressive in order to gain market share from rival firms. Businesses that rely on high sales volume to earn profits, such as supermarkets, aim to increase the number of distribution channels to ensure maximum sales (see Chapter 30).

Human resource management (HRM) implications

The role of operations management has a direct impact on human resource management. For example, a change in production methods can either reduce or increase the size of the workforce. Many multinational companies managed to enter China (prior to its membership of the World Trade Organization) by setting up labour-intensive operations. For instance, Black & Decker (the American power tools manufacturer) hires a large number of workers in its Shenzhen plant even though many of the operations could easily be automated. This is a deliberate strategic choice and helps to create employment opportunities in overseas markets. Alternatively, mass production uses capital-intensive technologies so tends to deskill the workforce.

Motivation can also be affected by aspects of operations management. Whilst mass production methods suffer from a lack of teamwork and group dynamics, job production can benefit from using the individual skills of people working within a team for a specific job (see Chapter 36). There are also training implications. Job production techniques require more training whereas mass production requires minimal instructional training only. It is relatively easy to hire workers for mass production whereas attractive remuneration packages may be needed to entice specialist workers for job production. Crisis management (see Chapter 41) can be highly disruptive and unsettling for employees, so effective contingency plans are needed.

Finance implications

Capital intensity (see Chapter 40) and lean production methods (see Chapter 37) require heavy investment in machinery and equipment. This is expensive, although the fixed investment costs can be spread over time with mass production. Capital-intensive organizations are likely to use investment appraisal techniques (see Chapter 21) in order to assess whether the risks of capital expenditure are worthwhile. They are also likely to need external sources of finance (see Chapter 15) to fund the investment projects.

A contingency fund (finance kept for emergency use) may also be reserved in case of machinery breakdowns, late deliveries from a supplier or any other unexpected event that would delay production. By contrast, labour-intensive production requires a greater proportion of a firm's cost to go into remunerating workers with wages, salaries and other financial benefits (see Chapter 10).



Figure 35.2 - The role of operations management has a direct impact on a firm's finances

The role of operations management can also be explained by looking at the goods produced and/or services provided by a business organization. Operations management does not only apply to manufacturing because production is concerned with all four production sectors of the economy (see Chapter 1):

- **Primary sector** - This sector of the economy deals with the extraction of raw materials, harvesting of crops and rearing of animals, such as mining, agriculture and fishing.
- **Secondary sector** - This involves production processes to turn natural resources into processed or finished goods, such as steel production and car manufacturing.
- **Tertiary sector** - This refers to the provision of services, such as finance, insurance, travel and tourism, transportation and healthcare.
- **Quaternary sector** - This refers to the provision of intellectual and knowledge-based activities and involves the generation and sharing of information, such as information and communications technology (ICT), research and development (R&D), consultancy services and scientific research.

Essentially, the role of production is to turn **factors of production** (comprised of land, labour and capital resources as well as entrepreneurship) into the output of goods and services in a cost-effective way. Figure 35.2 shows a simplistic model of the **production process** (or **transformation process**), which refers to the methods used to turn factor inputs into outputs of finished product by adding value in a cost-effective way.

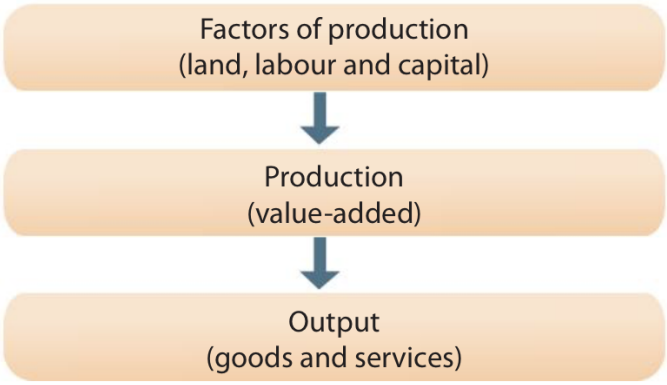

Figure 35.3 - The transformation (production) process

The factors of production are the resources used in the production process. They are commonly known to marketing and production managers as the Five Ms - Materials, Manpower, Money, Machines and Management, i.e., the available resources to a business for production purposes. The 5 Ms can be a useful tool in devising both marketing and production plans. They are combined in a cost-effective way to ensure that the transformation process adds value during the 'production' stage, i.e., the value of the output is greater than the costs of production, thereby earning a profit for the business.

To ensure that output can be sold for more than the input costs, production managers need to deal with several key aspects of operations management, including the following roles:

- Methods of production (see Chapter 36)
- Size, scope and timing of production (see Chapter 5)
- Production planning, e.g., stock control systems (see Chapter 40)
- Quality control systems (see Chapter 37)
- Contingency planning and crisis management (see Chapter 41) and
- Research & Development (see Chapter 42).



Figure 35.4 - Cars are typically mass produced using computerised systems and quality controllers

The role of operations management looks at the need for businesses to decide how production should take place. For example, the type of product (such as a haircut or a commercial building) will affect the production method chosen. Even the same kind of product can be produced using different methods, such as Casio watches and Rolex watches. Operations methods are explained further in Chapter 36.

The role of operations management and the key concepts

In an ever-changing business environment, organizations are continually trying to improve their operational efficiency. In its simplest sense, efficiency occurs when a business operates at its maximum output with minimum costs per unit of output. Efficiency is, therefore, a measure of how well a business uses its resources in the production process. An inefficient business can have high unit costs due to its idle resources (human and capital resources that are not used effectively yet contribute towards the firm's costs). This is unsustainable, so such organizations become uncompetitive and might not survive in the long-term. Many businesses have collapsed or been acquired due to their inefficiencies in production. For example, Concorde proved highly unprofitable despite its unique selling point (supersonic air travel) and ceased operation in 2003. Changes in the industry, such as the introduction of low-cost airlines, also caused major problems for Concorde.



Figure 35.5 - Operational inefficiencies caused the eventual collapse of Concorde

Technological changes and product innovations have meant that productivity can often be improved by using modern equipment and machinery. **Productivity** is the rate at which inputs are transformed into outputs and are a good measure of a firm's operational efficiency level. For example, the productivity of Post Office staff can be measured by the number of customers who are served per period of time.

Alternatively, managers can also use financial and non-financial methods of motivation (see Chapter 10) to raise labour productivity. However, achieving a higher level of productivity and operational efficiency is not straightforward. In reality, businesses may not be able to afford such technologies, despite their likely benefits. There is also likely to be resistance to change from the workforce due to the uncertainty of new working practices and the potential threat of redundancies. In any case, businesses will strive to stay competitive by looking at the various aspects of their operations and how they can raise productivity levels in sustainable ways.

Modern management thinking has led to production strategies that consider more efficient and sustainable operations, such as the use of total quality management in the workplace (see Chapter 37) and just-in-time stock management (see Chapter 40). Business strategy cannot simultaneously and sustainably aim for high quality products at low prices. Instead, operations strategy must focus on either earning high profit margins by selling unique products of outstanding quality or on selling mass market products that earn low profit margins but sell in large volumes. There is a potential trade-off between quality and productivity; businesses cannot simply speed up production of goods without sacrificing quality standards. The decision of operations managers will therefore have an implication on the type of production method used (see Chapter 36).

Attitudes towards sustainability also have a huge and direct impact on the role of operations management. John Elkington, a major leading authority on corporate responsibility and sustainable development, argues that organizations need to embrace social justices, such as the fair treatment of women in the workplace. Such a shift in corporate attitudes can result in many business opportunities beyond arguments about sustainability, such as productivity gains, improved staff morale and a more positive corporate image. Ethically, greater gender equality is part of the United Nations Development Programme (UNDP)'s Sustainable Development Goals. Hence, a change in the culture of empowering women is vital to both economic and social sustainability in the long term.

ATL Activity 35.1 (Research and Thinking skills) - The UNDP SDG

Go to the UNDP's website (https://www.undp.org/sustainable-development-goals) and choose one of the 17 Sustainable Development Goals to investigate, addressing the following two questions in particular.



Source: UNDP (https://www.un.org/sustainabledevelopment/blog/2015/12/sustainable-development-goals-kick-off-with-start-of-new-year/)

1. In the context of a business organization of your choice, how does this SDG impact on operations management?
2. To what extent is your chosen SDG likely to be achieved in the country you live in by the 2030 target set by the UN?

Key concept

With reference to an organization that you have studied, examine how **sustainability** has impacted on its operations management **strategy**

You might find it useful to refer to Chapter 59 and read the section on sustainability before attempting the following question 35.1 below.

Question 35.1 - Plastic carrier bag levy

Prior to July 2009, residents in Hong Kong used an average of 30 million non-biodegradable plastic carrier bags every day! For a relatively small population of 7 million people back then, this meant the average person in the Hong Kong Special Administrative Region of the People's Republic of China was using more than four plastic carrier bags every day, often on a single-use basis. This staggering figure meant that Hong Kong's landfills struggled to cope with the volume of plastic carrier bags being thrown away.

The introduction of a HK$0.50 tax (6.5 US cents) on the use of each carrier bag encouraged people to use eco-friendly reusable shopping bags and to be aware of **environmental sustainability**. Demand for plastic carrier bags fell by 85% within the first two days of the tax being introduced. The decision by lawmakers followed similar moves made in Ireland (in 2002) and the People's Republic of China (in 2009). The United Nations reported that 77 countries across the world had imposed full or partial bans on plastic carrier bags by the start of 2022.

(a) Define the term *environmental sustainability*. *[2 marks]*

(b) Discuss the use of taxes, such as the charge on plastic carrier bags, to achieve environmental sustainability. *[10 marks]*

Topic 5: Operations management

REVIEW QUESTIONS

1. What is meant by operations management?
2. What are the marketing implications of operations management?
3. What are the human resource management (HRM) implications of operations management?
4. What are the financial implications of operations management?
5. How are the four production sectors of the economy affected by operations management?
6. What is the production (or transformation) process?
7. How does the production process 'add value' to output of goods and services?
8. Why is operational efficiency important to businesses?
9. What is meant by productivity?
10. Why is sustainability of importance to operations management?

KEY TERMS

Factors of production are the resources needed to produce a good or service, namely land, labour, capital and enterprise.

Operations management (or **production**) is concerned with providing the right goods and services in the right quantities and at the right quality level in a cost-effective and timely manner.

The **production process** (or the **transformation process**) refers to the method of turning factor inputs into outputs by adding value in a cost-effective way.

Productivity is a measure of a firm's operational efficiency level, calculating the rate at which inputs (factors of production) are transformed into outputs (good and services).

Sustainability is the practice of enabling production and consumption of goods and services for the people of today without compromising the needs of future generations.

Value added occurs during the production process when the value of output is greater than the costs of production. Firms earn profit if value added exists in the production process.



Figure 35.6 - Car manufacturing is an example of production

Chapter 36
Unit 5.2 - Operations methods

"Consumption is the sole end and purpose of all production."
- Adam Smith (1723 - 1790), Scottish philosopher and economist

Contents

5.2 Operations methods	
SL/HL content	**Depth of teaching**
The following operations methods: • job production • batch production • mass/flow standardized production • mass customization	AO3

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Operations methods

The main function of businesses is to provide goods and services to meet the needs and wants of customers. To be able to do this, they need to be able to turn inputs into outputs. Production is the process of turning inputs (such as raw materials and components) into outputs (finished products) for sale to customers. **Operations methods** refer to the specific methods by which production takes place. The following operations methods are listed in the syllabus: (i) job production, (ii) batch production, (iii) mass/flow production and (iv) mass customization. (AO3)

Job production (AO3)

Job production involves customizing an individual product from start to finish, tailor made to meet the specific requirements of the client. Typically, these products are one-off and unique items such as an office building, a wedding dress, a Hollywood movie, music composition, portrait painting, private dance lesson or a haircut. A single worker (such as a tailor) or a group of workers (such as a team of painters and decorators or architects and engineers) handle the complete job.

Job production (or **customized production**) covers a whole range of tasks from those that are small scale involving little or no technology (such as a private tutor or a hairdresser) to complex jobs that cannot be completed without high technology (such as the construction of a hotel, theme park or bridge). Job production is **labour intensive**, meaning that the production process relies heavily on labour inputs, so the cost of labour accounts for the largest proportion of a firm's overall production costs. It is most apparent in the provision of personalized services, such as lawyers, accountants, beauty therapists, masseurs and caregivers. The advantages and disadvantages of job production are outlined in Table 36.1 below.



Figure 36.1 - Tower Bridge in London, UK was built between 1886 and 1894 using job production

Table 36.1 - The advantages and disadvantages of job production

Advantages of job production	Disadvantages of job production
Quality of production (and service delivery) because highly skilled labour is used. For example, a wedding planner is able to give customers far more personal attention than a supermarket cashier would for individual customers.	The production process is highly **time consuming** due to the varying and specific requirements of customers. It is usually difficult and impractical to speed up production as product specifications and quality standards need to be followed.
Motivation of workers is likely to be very high. They can feel proud of the finished project, such as a tailor-made pair of shoes or a prestigious hand-made sports car. Team spirit can also be a motivating factor (see Chapter 10).	It tends to be highly **labour-intensive** and is therefore an expensive operations method. As wages and salaries account for the largest share of costs in most firms, the final price charged reflects the high costs of job production.
Flexibility during the planning stages is possible as each product's design and specifications can be altered according to the customer's requests such as the type of car and flowers for a wedding. It is often possible to change the specifications of a job even when the work has already begun. This flexibility can provide major marketing benefits for a business.	There is a relatively **long time lag** from receiving the order and receiving the payment from the client due to the length of time involved in job production. For example, Ferrari has a 5-year waiting list for its bespoke cars, so clients do not fully pay for their purchases until the cars are delivered. However, during this time, Ferrari still needs cash to pay for its costs.
Uniqueness of the product not only helps to maintain motivation but adds value to the production process. The exclusivity can act as a unique selling point (USP) for the business and helps to secure a premium price for the finished product.	**Few economies of scale** can be enjoyed as each good or service is unique rather than produced in large batches. A tailor might enjoy some economies of scale from buying materials in bulk, but then faces storage and higher insurance costs.
The customisation of job production creates a variety of **choice** for the customer that cannot be met by other methods of production.	The **irregularity of orders** means that production is unpredictable, so can cause cash flow problems (see Chapter 20) for the business.

Question 36.1 - Bristol Cars



Bristol Cars is a producer of luxury cars, founded in 1945 in Bristol, UK. Only around 100 cars are made per year. Each car is uniquely produced, allowing the firm to claim that the Bristol Car is "*Great Britain's most exclusive luxury car.*" The **privately held company** does not have any distributors or dealerships. Every part of the car is given the necessary time and attention to detail to satisfy both the client and the company. Only when each task is done to perfection can the highly skilled workers move onto the next task. The cost of perfection means it can take a long time to produce each car, but Bristol Cars claims that "*the car is produced for those who can afford and appreciate the best.*" A designated salesperson ensures that each customer receives a highly personalised service, even after the sale of the car. Their all-electric sports cars start at a price of £495,000 ($693,000) before taxes.

(a) Define the term *privately held company*. *[2 marks]*

(b) Explain the operations method used by Bristol Cars. *[4 marks]*

(c) Discuss the impact of this operations method for Bristol Cars, its employees and its customers. *[10 marks]*

Case study 36.1 - Aquazzura

Italian luxury shoe brand Aquazzura makes its shoes in a small factory in Florence, Italy. Aquazzura shoes can take up to 10 months to produce. Up to 120 skilled labourers are used to produce a single high heel shoe. Much of the work is completed by hand, but machines are used to help finish certain aspects of each shoe. The workers use some techniques that are over 100 years old.



Figure 36.2 - Batch production is commonly used in bakeries

Batch production (AO3)

Batch production involves simultaneously producing a number of identical products (known as a **batch**). Work on each batch is fully completed before production switches to another batch, using the same team of workers and machinery. For example, a small bakery might produce 12 loaves of bread before changing production systems to bake 24 blueberry muffins.

This operations method is highly suited to businesses that make a range of products, unlike with job production. Clothing retailers such as H&M and Gap have their garments produced in batches of different sizes and colours. Hotels that offer buffet dinners prepare and cook food in batches. The main advantages and disadvantages of batch production are outlined in Table 36.2.

Batch production tends to be used when the level of demand for a product is not clear. Instead, estimates of sales volumes are made and carefully monitored. Output can then be adjusted accordingly. Production of one product line can be stopped, if necessary, perhaps to work on another more urgent batch

Common mistake

Students often comment that batch production is only suitable when small quantities are being produced. Whilst this is true to some extent, batch production can also be used to produce large quantities of output. However, production is not continuous as in the case of mass production and flow production.

Table 36.2 - The advantages and disadvantages of batch production

Advantages of batch production	Disadvantages of batch production
Economies of scale can be enjoyed as machinery can be used to produce larger quantities (*technical economies*). Raw materials and components can also be bought in bulk (*purchasing economies*).	**Storage** is important as batch production can result in a high amount of stock (inventory). However, this increases costs, such as storage costs and insurance against damage or loss of the stock.
Specialization in the different production processes is likely to lead to increased *productivity* (output per worker) and better-quality products.	As with all systems of division of labour, jobs can get repetitive and lead to **boredom**. This might therefore reduce motivation and productive efficiency.
As a **variety** of products can be made, so customers have more choice. For example, birthday cakes or t-shirts made in batches gives individual customers a degree of choice at a relatively low cost.	A degree of **inflexibility** exists because once the production run for a batch has started, it is difficult to switch to or work on another batch. Hence, this can cause delays to the overall production process.
Variety can **reduce risks** of producing just a single product with limited sales potential.	There can be relatively **high production costs** due to the reliance on specialized machinery and equipment.

Mass/flow production (AO3)

Mass production is the manufacturing of large amounts of a standardized product. It often involves the assembly of individual components, with parts (components) bought from other suppliers. It tends to be *capital-intensive*, which means the manufacturing or provision of a product relies heavily on machinery and equipment, such as automated production systems. Hence, the cost of capital accounts for the largest proportion of a capital-intensive firm's overall production costs.

An essential aspect of mass production is *specialization* - the use of dedicated capital equipment and skilled labour to carry out a different function essential to the overall production process, resulting in higher levels of productivity. Therefore, average costs of production are relatively low enabling the business to experience economies of scale (see Chapter 6).

Mass production was first commercialised by Henry Ford in the USA. Ford, who was heavily influenced by the work of F.W. Taylor (see Chapter 10), introduced the world's first automated production line in the 1920s for the production of his 'Model T' cars. Instead of the workers moving from one workstation to another (which is rather inefficient), he used an automated production line to boost the firm's productivity.

Unlike batch production, the standardized products made using mass production are produced or assembled on a much larger scale. **Standardization** means producing an identical or homogeneous product in large quantities. Examples of mass-produced goods include ball bearings, buttons, computer microprocessors, LEGO toy bricks, mass-market motorcars, paracetamol pills and textbooks.



Figure 36.3 - Textbooks are mass produced in a standardised format to lower average costs

Flow production is a form of mass production that uses continuous and progressive processes, carried out in sequence. When one task is completed, the next stage of production starts immediately. For every-day convenience goods, such as canned drinks or bottled water, assembly lines can be kept running 24 hours a day, seven days a week to maximise output and to eliminate waste (the extra costs of starting and stopping the production process). Therefore, flow production relies entirely on automated systems with very few workers required. For example, at full capacity, the Coca-Cola Company uses flow production processes to make 10,000 bottles of water in a single factory every minute of the day!



Figure 36.4 - Flow production relies on automated processes

Producers of bottled water, beer, toothpicks, screws and nails and use a system similar to the one shown in Figure 36.5. Larger newspaper publishers that print millions of identical copies of a particular daily newspaper also use flow production using specialised production lines. The main advantages and disadvantages of mass and flow production are outlined in Table 36.3.

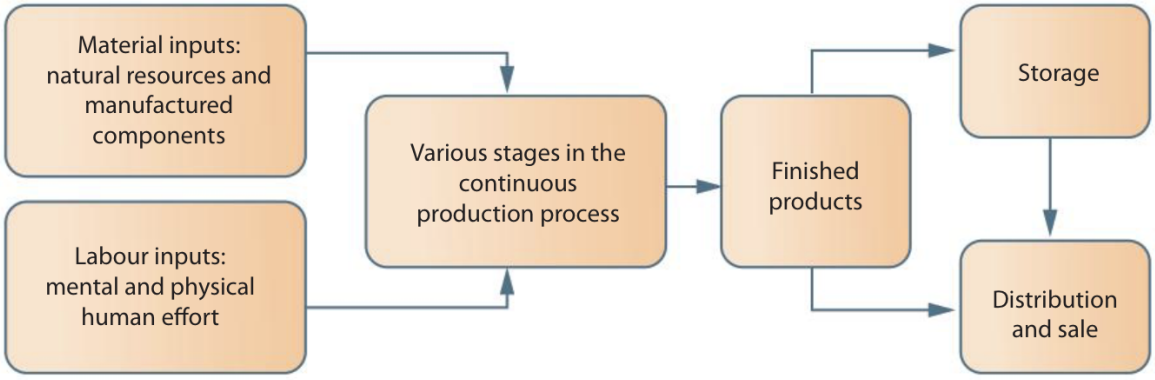

Figure 36.5 - Basic flow production process

Table 36.3 - The advantages and disadvantages of mass/flow production

Advantages of batch production	Disadvantages of batch production
Large volumes of output exist as these production methods are capital-intensive, so output occurs on a large scale. For example, Coca-Cola produces 2,000 cans of Coke per minute when operating at full capacity at its bottling plant.	The work is likely to be **monotonous** and therefore **boring** for workers. For example, designated workers at Coca-Cola check every glass bottle to ensure that there are no cracks or defects before any beverage is poured into them.
These methods are the most **cost-effective** operations method as costs can be spread over the high volume of output, thereby reducing average fixed costs through technical economies of scale. Machines can work 24/7 if necessary. Machines may break down from time to time, but they do not require wages, rest breaks or motivating, which helps to reduce costs of production in the long run.	There is **limited choice** because products are standardized. Changes cannot be made to meet a customer's individual needs. Once the production process begins, there is no opportunity to change the design or specifications. There can be some variety to the finishing touches towards the end of the assembly line, such as colour, although these are also produced on a relatively large scale.
The use of dedicated (specialized) machinery and equipment means that products are of a standardized quality. Workers also specialize so become experts in their area of the production process. This enables the business to achieve a **low defect rate** (see Chapter 37) and to maintain quality standards.	The methods are capital intensive and thus involve **expensive costs**, including set-up costs (e.g., purchase and installation), running costs (e.g. servicing and maintenance) and replacement costs (when equipment becomes obsolete). The reliance on assembly lines means any breakdowns will cause major problems.
Low labour costs because relatively unskilled workers are required to operate the machinery, such as Foxconn workers in Chennai, India who work 10-hour shifts, earning the minimum wage. Low-skilled workers can be hired easily and trained to work on the assembly line within a couple of hours.	The systems are **inflexible** - unlike job or batch production, it is not possible to rework products that are sub-standard as mass/flow production is continuous. Any reworking will bring other operations to a halt. Large scale output also means the need for an effective storage system due to the large volume of stock (inventory).

Exam tip !

In reality, it is not always so straightforward to classify operations methods as job, batch or mass/flow production. Many goods are made using a combination of operations methods. For example, a tailor-made suit uses job production with labour-intensive techniques. Even though the suit is made to the individual requirements of the customer, the materials (such as the cloth, thread and buttons) are bought in batches.

Question 36.2 - Operations methods

Describe the most appropriate method of production for each product below:

(a) Navy battleships *[2 marks]*
(b) Wedding cakes *[2 marks]*
(c) Cookies (biscuits) *[2 marks]*
(d) Samsung smartphones *[2 marks]*
(e) Evian bottled mineral water. *[2 marks]*



Theory of Knowledge (TOK)

How might we determine the true costs of production for goods such as 'blood diamonds' or cheap (genetically modified) food products?

CORE

Mass customization (AO3)

In reality, businesses are likely to combine different methods of production. For example, Burger King generally uses batch production. However, it also uses job production to a lesser extent - its corporate slogan '*Have it your way*' is based on the notion that customers can customise their burgers as long as the ingredients are available. This approach is known as **mass customization**, which is the use of flexible manufacturing systems to mass produce products that meet individual consumer needs and wants. It benefits from the low unit costs of mass/flow production processes with the flexibility of individual customization of the product.

A common approach used by businesses is to offer a basic package for a product and then offer customers a range of features they can add or subtract. For example, Cadbury's and Coca-Cola have used mass customization technique that enables customers to have their names printed on the packaging. Apple's MacBook laptops are available in different specifications, such as hard drive capacities, screen sizes, processor speeds, RAM sizes and the colour to provide customers with a greater degree of choice to match their needs and budgets. Mass customization enables the product to be built to order.

Mass customization has grown in popularity enticing people striving to be unique and own something special. The highly successful BMW Mini, for example, is produced according to the exact number of orders. Customers can customise their cars from BMW's predetermined options list. This is possible due to BMW's use of advanced automation technologies. The result is that Mini customers get a personalised product with the added benefit of lower production costs from the use of mass production processes.



Figure 36.6 - The Mini is made using a combination of production methods

Question 36.3 - Categorizing operations methods

Explain why it might not be straightforward to categorize the operations methods used to produce the following products:

(a) Dell personal computers that are made to order, i.e. customers set their own product specifications. *[4 marks]*

(b) Birthday cakes sold at large supermarket chains such as Carrefour, Tesco and Walmart. *[4 marks]*

The choice of operations method depends on the appropriateness for the business. This in turn depends on several factors, including:

- The size of the market - Larger markets tend to use capital-intensive technologies and hence mass and flow production methods are more appropriate. By contrast, smaller firms are likely to use batch production or job production.
- The relative cost of labour and capital - Assuming that substitution of resources is feasible, relatively higher labour costs could mean that the business chooses to use more capital-intensive production methods, such as batch and mass/flow production.
- The aims and objectives of the organization - If profit is the main objective, then businesses are more likely to want to operate in mass markets, thereby choosing to use more capital-intensive technologies to minimise unit costs of production. Businesses that are risk-adverse and worried about survival during a recession may prefer to operate at a smaller scale so that it is relatively easier to control costs.

ATL Activity 36.1 (Research skills)

Visit the "How It's Made" YouTube channel (shorturl.at/eflJ7) and investigate how everyday products are made.

You can choose any one of the products from the home page or search for videos of your choice, such as balloons, parachutes, newspapers, toothpicks, helicopters or even tofu! Make notes on the different operations methods and be prepared to discuss your findings with the rest of the class.

Operations methods and the key concepts

The concept of change can have a direct impact on the choice of operations method in relation to the stage of the product's life cycle. Favourable market changes can mean that a business switches from batch production to mass production, for example. Changes in technologies and innovations have also given businesses more opportunities, such as the use of 3D printing for mass customization production.

Ethics can influence the choice of suppliers or outsourced providers. Apple had to intervene with Foxconn, its outsourced producer of iPhones, due to media exposure of unethical business practices in Foxconn's production plants in southern India. Nevertheless, the pressures of international competition have led many businesses to use outsourced and offshored suppliers (see Chapter 38), despite potential issues arising from ethical matters such as poor working conditions for local labourers.

Key concept

Different production methods have varying implications on the other strategic functions of a business (such as human resources, finances and marketing). Discuss how **creativity** might influence a firm's choice of operations method and how this might affect other aspects of operations management.

Key concept

With reference to an organization of your choice, examine how **change** and **ethics** have influenced its operations methods (methods of production).

Business Management Toolkit

Discuss why it might be important for a business plan (see Chapter 48) to include details of an organization's production method(s), as well as its strategies for sustainability.

Topic 5: Operations management

REVIEW QUESTIONS

1. What is meant by operations management?
2. What is job production?
3. What are the main advantages of job production?
4. What are the main disadvantages of job production?
5. What is batch production?
6. What are the main advantages of batch production?
7. What are the main disadvantages of batch production?
8. What is mass production?
9. What is flow production?
10. What are the advantages of mass and flow production methods?
11. What are the disadvantages of mass and flow production methods?
12. What is meant by mass customization?
13. What factors affect the choice of operations methods used by a business?

KEY TERMS

Batch production involves producing a set of identical products. Work on each batch is fully completed before production switches to another batch.

Capital intensive means that the manufacturing or provision of a product relies heavily on machinery and equipment, such as automated production systems.

Flow production is a form of mass production that uses continuous and progressive processes, carried out in sequence. When one task is completed, the next stage of production starts immediately.

Mass customization is an operations method that uses flexible manufacturing systems to mass produce products that meet individual consumer needs and wants.

Mass production is the large-scale manufacturing of a homogeneous (standardized) product. Unit costs of production are relatively low when using mass production methods.

Job production involves the manufacturing of a unique product or one-off job. The job can be completed by one person (such as a tailor) or by a team of people (such as architects and engineers).

Labour intensive means that production relies heavily on labour inputs, so the cost of labour accounts for the largest proportion of a firm's overall production costs. It is most apparent in the provision of personalized services.

Standardization means producing an identical or homogeneous product in large quantities, such as printing a particular magazine, book or newspaper.

Chapter 37

Unit 5.3 - Lean production and quality management (HL only)

"I'm a slow walker, but I never walk back."
- Abraham Lincoln (1809 - 1865), 16th President of the USA

Contents

5.3 Lean production and quality management (HL only)	
HL content	**Depth of teaching**
The following features of lean production: • less waste • greater efficiency	AO1
The following methods of lean production:: • continuous improvement (kaizen) • just-in-time (JIT)	AO2
Features of cradle to cradle design and manufacturing	AO2
Features of quality control and quality assurance	AO2
The following methods of managing quality: • quality circle • benchmarking • total quality management (TQM)	AO2
The impact of lean production and TQM on an organization	AO3
The importance of national and international quality standards	AO2

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Features of lean production

The following features of lean production: less waste and greater efficiency. AO1

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Lean production is the process of streamlining operations and processes to reduce all forms of waste and to achieve greater operational efficiency. **Waste** refers to anything that prevents an organization from being efficient or lean, e.g., product defects, stockpiling and overproduction. Thus, lean production should lead to improved quality and reduced costs. It was first used in Japan during the 1950s. Businesses are increasingly trying to reduce wastage (or muda, the Japanese term for 'waste') in the production process. "OTHER"© examples of **muda** include:

- **O**ver-processing - This means a business adds more features or functions to a product than is necessary to meet the needs of customers. Over-processing does not add much

value for the customer but increases the organization's production costs. Consider the many functions and features on your smartphone or computer that you do not use (or are even aware of).

- **T**ime - Delays in the production process (perhaps due to inefficient machinery or poor training) or the delivery process have a large negative impact on productivity and perceptions of quality. Delays can also occur due to excess movement of employees between workstations, which wastes time and reduces labour productivity.

- **H**uman effort - Tasks may need to be reworked (done again) due to waste from substandard and defective output.

- **E**nergy - Leaving on lights, heating or air conditioning when not needed is a huge and unnecessary drain on scarce financial resources.

- **R**esources and materials - There can be wastage of materials and resources that have not been used efficiently, such as floor space. Wastage also occurs if there is underproduction (resulting in shortages and causing a loss of potential customers) or overproduction (producing more than necessary, which leads to stockpiling).



Figure 37.1 - Overstocking is a source of muda (waste)

In adopting lean production, several principles are followed which also help to achieve greater efficiency:

- *Waste minimization* - This requires the business to remove any operation or process that does not add value to the product. It involves making more efficient use of a firm's scarce resources (its land, labour and capital resources).

- *'Right first time' approach* - Businesses aim for zero defects by identifying and resolving all problems at source. It is more efficient to use resources to prevent mistakes rather than trying to correct them as this eliminates the need for quality controllers to spend time checking the quality of the output.

- *Flexibility* - Resources must be adaptable to the changing needs of the business, e.g., firms might use multi-skilled workers who can work on several projects simultaneously (see Chapter 7).

- *Continuous improvement (Kaizen)* - Lean production requires the continual strive to improve quality and efficiency, thereby reducing average costs of production.

- *Supply Chain Management* - Businesses must develop and maintain good professional working relationships with their suppliers and intermediaries to help streamline the supply chain process (see Chapter 40).



Figure 37.2 - Lean production aims to eliminate waste

Methods of lean production

The following methods of lean production: continuous improvement (Kaizen) and just-in-time (JIT). AO2

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Continuous improvement (Kaizen)

Dutch artist Vincent Van Gogh (1853 - 1890) said that "*Great things are not done by impulse, but by a series of small things brought together.*" **Kaizen** is the Japanese word for a philosophy of **continuous improvement**. Kaizen is made up of two words - 'Kai' meaning *change* and 'Zen' meaning *better*. Hence, Kaizen comes about by changing for the better. It has become a widespread approach in the workplace where workers

and managers continually try to find ways to improve work processes and efficiency.

The concept of Kaizen is therefore a process of productivity and efficiency gains that come from *small* and *continuous* improvements being made, rather than a large one-off improvement. Efficiency means using resources more productively, in order to generate more output in a cost-effective way. The Turkish have a saying that "*Stairs are climbed step by step*". *Confucius, the Chinese philosopher, said "It does not matter how slowly you go so long as you do not stop.*" These sayings are similar to the famous children's fable about the hare and the tortoise (see Box 37.1).



Figure 37.3 - Kaizen is about making small steps to continually improve

Box 37.1 - The hare and the tortoise (a case of continuous improvement)

A hare and a tortoise were in a race together. The hare thought that its natural superiority would mean winning the race would be simple. The hare leapt ahead and after a short while the tortoise was nowhere in sight. Complacent, the hare decided to take a rest and fell asleep. This allowed the tortoise, with its small but continuous steps, to eventually overtake the hare and win the race.

The Kaizen process typically involves forming small groups of employees who identify changes and improvements to the organization's products, processes and procedures. The aim is to establish a steady flow of small improvements rather than one-off and/or radical changes. This is partly because people tend to be resistant to change, especially change that is large scale and disruptive to the organization. Change is easier to manage when there are small and continuous improvements. Kaizen groups do not tend to directly look at cost cutting; the focus remains on continual improvements in quality. However, by doing so, Kaizen often brings about cost savings.

Kaizen also aims to eliminate waste by looking at ways to improve the productivity and efficiency of the firm's operations. For example, if a worker is late to work for just one minute each day, that equates to 5 minutes per week or over 4 hours per year. If this was the norm for a workforce of 50 people, then the lost production time would be over 200 hours each year (or around 25 days of lost output). Kaizen is therefore an integral part of quality management.

The philosophy behind Kaizen is that anyone in the organization, irrespective of their rank, can contribute. The best suggestions often come from employees who have direct contact with customers. They are the ones best positioned to understand the benefits of changes to certain operations. This has the added benefit of motivating staff as they are able to use their initiative and have some input in the decision-making process.

Just-in-time (JIT)

Just-in-time (JIT) is an inventory management system based on stocks being delivered as and when they are needed in the production process. As stocks are delivered just before they are used, there is no need to have a buffer stock (see Chapter 40). Finished goods are dispatched as soon as they have been produced, thereby eliminating the need for storage. JIT, a Japanese philosophy first advocated by former Toyota Executive Taiichi Ohno, is a method of lean production because high inventories are costly and wasteful.

JIT is common in car manufacturing. For example, the BMW Mini is assembled using a JIT system. A customer places a specific order before the vehicle is made. Each component is ordered to be available when needed for production. The use of bar codes for these components helps to ensure the right parts are supplied at the right time. Unlike traditional assembly lines used in mass production (see Chapter 36), JIT allows a series of BMW Mini cars, all of different colours and engine sizes, to be produced on the same production line. The JIT system

relies on automation, bar codes and the use of highly skilled and motivated workers. The advantages and disadvantages of JIT are covered in Chapter 39.

Lean production is a philosophical vision for businesses. In reality, it can never truly be achieved. However, this does not stop organizations trying to make lean production become the cultural norm (in terms of employee attitudes and operational procedures), due to the benefits of reduced waste (such as cutting unnecessary costs), reduced defects and improved efficiency.

Case study 37.1

How's this for an example of lean production? On 17th November 2017, the Metropolitan Intercity Railway Company, a Japanese rail operator, formally apologized after one of its trains left *20 seconds too early*. A spokesperson for the rail company said the train conductor had not checked the train's timetable properly and added that employees were instructed to follow procedures strictly to prevent a recurrence. For passengers who missed the train, the next scheduled one arrived (on time) four minutes later.

Common mistake

Students often comment that lean production gives a business a significant competitive advantage over its rivals. Whilst this can be true, make sure you substantiate your comment. This competitive advantage will not exist if, for example, competitors have access to the same lean production technologies or if the firm has to use lean production technologies just to keep pace with market leaders.

Cradle to cradle design and manufacturing

Features of cradle to cradle design and manufacturing. AO2

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Cradle to cradle (C2C) refers to a sustainable model of production based on natural processes, thus benefiting the environment. The underlying principle of C2C is that there is no waste in nature, making it sustainable. This implies that C2C manufacturing is designed in such a way that production is efficient and generates minimal or no waste, so is sustainable for future generations.

By contrast, **cradle to grave** refers to one-time use of a product, which is the most common form of manufacturing. Have you ever noticed the amount of waste products from a single Happy Meal® or Extra Value Meal® at McDonald's? The waste from each meal includes the paper mat, food wrapping, straw, paper cup, plastic paper cup lid, tissues, sauce wrappers and even uneaten food. According to the company's website (www.mcdonalds.com/), McDonald's services 3.5 million customers each day, so that represents a huge amount of waste.

Walter R. Stahel (born 1946), a Swiss architect, is credited for coining the term cradle to cradle in 1971. C2C provides a framework for operations managers to design production techniques that are efficient (free of waste) and sustainable, e.g., glass bottles are used in the production of beverages such as beer, soft drinks, water and wine. Glass bottles are quite easy to reuse and/or recycle. **Recycling** enables old materials to be reprocessed into new products, with the aim of preventing waste. **Reuse** of a resource is different from recycling as the product is not made into a new material or product. Reusing resources also prevents waste. Designing products or materials to be reused and/or recycled allows for improved sustainability. Another example is coffee cups made out of cornstarch - a biodegradable component. These cups can be used, reused and eventually composted, supplying nutrients to plants or crops.



Figure 37.4 - Most glass products are C2C but some are easier to recycle than others

Buildings (such as homes and offices) are increasingly being made using C2C processes. Technical components of the building ensure materials are not toxic. The building is designed and manufactured in an environmentally friendly way. The C2C approach also minimizes the environmental impact of

disposal in order to promote sustainability. Hence, the C2C philosophy is an important component of a firm's corporate social responsibility (CSR).

Businesses that adopt a C2C philosophy design and manufacture products that are ecologically and environmentally friendly. C2C practices enable businesses to repeatedly use the same components rather than disposing of them because products can be either reused in the production process or broken down organically as food for the natural environment. Critics of the C2C philosophy argue that such practices can restrict the ability of businesses to operate in a cost-effective and therefore efficient way.



Figure 37.5 - Eco-friendly businesses use C2C practices

ATL Activity 37.1 (Research and Communication skills)

The Aeron chair, made by Herman Miller, is a C2C product. Investigate what makes this product a good example of C2C design and manufacturing. What other products are also good examples of C2C? Be prepared to present your findings to the rest of the class.

Business Management Toolkit

Discuss how cradle to cradle design and manufacturing are essential aspects of any circular business model (see Chapter 51).

Quality control and Quality assurance

Features of quality control and quality assurance. AO2

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Quality means that a product fulfils its purpose and meets the expectations of the consumer. Hence, quality is not exclusive to expensive products. A Honda or Ford car can be of good quality so long as the vehicles meet the quality standards of the industry and the requirements of customers. Likewise, the quality of teaching and learning in a government funded school is not necessarily inferior to that offered at an expensive fee-paying private school.

Products that do not meet the needs or expectations of customers, producers or governments are said to be **substandard**. Such products can be very costly to a business (see Box 37.2). Customers perceive quality by observing and comparing several interrelated factors, including:

- *Physical appearance and design* - Are the look, design and features of the product appealing to customers?
- *Image and reputation of manufacturer or seller* - A widely known and reputable brand will tend to be associated with higher quality.
- *Reliability* - Good quality products are of high quality, e.g., Lexus is renowned for building some of the world's most reliable cars and hence are of good quality.
- *Durability* - This is the extent to which a product will last. Products that need to be replaced or are in regular need of maintenance are regarded to be of poor quality.
- *Fit for purpose* - How well does the product fulfill its purpose? For example, how accurate is the watch, how tasty is the meal and how waterproof and wind resistant is the raincoat?
- *Safety features* - Products that are safe to use are considered to be of good quality. By contrast, products that need to be recalled due to safety problems are of substandard quality (see Question 37.2).
- *Customer service* - High quality firms provide outstanding customer service, such as knowledgeable, caring and courteous staff.

- *After-sales services* - These are customer services that occur following the purchase of a good or service. After-sales services can include guarantees, warranties, technical support, prompt delivery services and ensuring that spare parts are available and at reasonable prices.

Box 37.2 - The costs of poor quality

- Substandard quality will adversely affect the reputation of a business, perhaps irrevocably.
- Poor product design may lead to problems with the finished product, thereby affecting its demand. Customer complaints will rise, so customers are unlikely to purchase such products again.
- It costs time and money to rework the substandard products.
- Unsafe products can cause physical harm to customers.
- Equipment and machinery that regularly break down will need to be repaired. Hence, this adds to the costs of the business.
- Poor labour productivity (see Chapter 40) will raise average costs of production.
- Late deliveries can result in compensation claims being made and/or harm the firm's reputation.

Ultimately, poor quality harms the organization's competitiveness by affecting its reputation and costs in an unfavourable manner.

In essence, quality is determined by the perceived value for money. Customers assess what they get for their money by comparing the benefits of consumption with the price of the good or service.

Common mistake

Quality does not mean that a product has to be expensive, prestigious or exclusive. Many students incorrectly define quality as products that are the 'best' in their industry, such as Rolex or Cartier watches. There are plenty of high-quality watches that are relatively inexpensive.

The quality of an organization's products is important for two main reasons: its *reputation* and its ability to *control costs*. Four driving forces have led to quality being a paramount priority for many businesses:

- *Increasing consumer awareness* - Today's consumers have easier access to information, such as through consumer protection organizations, the mass media and the Internet. Any mistake made by large multinational companies is likely to be reported in various sources very quickly all over the world.
- *Increasing competition* - Rivalry has meant that firms that provide higher quality products may be able to benefit from brand loyalty and a larger customer base. Quality, as a form of product differentiation, can give a business a number of competitive advantages, such as a unique selling point (see Chapter 24).
- *Government legislation* - Changes and developments to competition laws have forced businesses in many industries to improve their quality standards.
- *Increasing consumer incomes* - With greater disposable income, consumers are more able and willing to buy higher quality products, such as high-end smart TVs and luxury motor vehicles.

Quality management is the function concerned with controlling business activities to ensure that products are fit for their purpose. Advocates of quality management argue that the quality of a product should be seen as an overall package, from the production and purchase of the product to its use and beyond. There are two main categories of quality management: (i) quality control and (ii) quality assurance.

Quality control (QC) is the traditional approach to quality management that involves inspecting, testing and sampling the quality of work. This approach to managing quality is mainly based on detecting faulty or poor-quality output, from the delivery of raw materials to the output of finished products. It requires products to be made to the required specification, which are checked by quality controllers. QC helps to identify problems such as substandard quality before products are sold to customers. The advantages and disadvantages of quality control are outlined in Table 37.1 below.

Table 37.1 - The advantages and disadvantages of quality control

Advantages of quality control	Disadvantages of quality control
QC is used to prevent faulty products reaching the customer, thereby preventing compensation claims and safeguarding the firm's reputation.	QC does not prevent mistakes being made yet can be expensive. Hence, quality assurance might be a better alternative.
It is cheaper to have trained QC inspectors than to have every individual being trained and empowered to be responsible for quality assurance.	The root cause of the problem is not dealt with as there is a lack of a quality culture, i.e., QC simply requires substandard output to be rejected or reworked.
QC inspectors can find widespread issues and problems across the organization, thereby facilitating continuous improvement.	Individuals are not accountable for the quality of the final output of work, so this approach can encourage slack.

Quality assurance (QA) is the management process of guaranteeing (assuring) the consumer of a product's quality by ensuring that everything is done 'right first time', i.e., there are no defects. It informs customers that the products have been made to the required specification and that certain quality standards have been met. QA can be an important source of competitive advantage. It is more concerned about preventing poor quality output than rectifying the problems. As American poet Henry Wadsworth Longfellow (1807 - 1882) said, "*It takes less time to do a thing right than to explain why you did it wrong.*"

In 1997, Mercedes-Benz launched its first small car - the A Class. The carmaker had spent close to $2 billion on the research and development of the product but found very shortly after the launch that there were major safety problems and had to recall all the cars sold. Mercedes-Benz spent another $280 million to fix the problems and, to their credit, the car has been a huge success ever since. Similarly, in 2010, Tata suffered an 85% drop in its sales of the Nano, the world's cheapest car at the time, following incidents of its cars catching fire.

The advantages of quality assurance include:

- QA programmes involve employee participation as workers have more ownership and recognition for their work. This helps to improve staff morale as they feel more valued.
- Employee participation can also help to generate new ideas for improving the quality of products, procedures (operations) and processes.
- QA can help break down an 'us and them' culture between employees and managers with their contrasting perspectives and priorities because there is no formal inspection of the work by quality controllers.
- There is less wastage and reworking as products, procedures and processes are checked at every stage of output. This helps to reduce production costs.

Disadvantages of quality assurance include:

- QA has high initial set-up costs, such as redesigning buildings and production facilities, as well as training and developing all employees in the organization.
- QA is time consuming as it requires a lot of time and resources to continually train staff. There is also the persistent effort needed to uphold a philosophy of all employees contributing to quality assurance.

In today's ever-competitive business environment, quality assurance is seen as being superior to traditional quality control as prevention of poor quality is far better than conventional methods of identifying defects and imperfections. However, QA requires significant time, energy and training to nurture a total quality culture within the organization.

Case study 37.2

In 2014, Kraft Foods recalled 96,000 lbs (43,545kg) of its Oscar Mayer hot dogs in the USA because they had been wrongly packaged as the company's Classic Cheese Dogs. Kraft's cheese sausages contain dairy products, which can cause some customers to have allergic reactions. In late 2021, Kraft Foods recalled an undisclosed number of several brands of its beverages, including Country Time Lemonade, Tang, Arizona Tea and Kool-Aid because they may have contained traces of small pieces of metal or glass.

Question 37.1 - Subway

Subway is a privately held company, founded in 1965, that specializes in the sale of fresh submarine sandwiches. Operating on a global scale, it is the world's largest **franchise** restaurant operator. The secret to its success has been the focus on promoting an image of being a health-conscious restaurant chain. With over 37,500 restaurants in more than 100 countries, **quality management** is a critical aspect of Subway's operations and its growth strategy. Its homepage (www.subway.com) has a dedicated section for customers to comment on their experiences at Subway, which helps the company to gain customer feedback to further improve its quality standards.



(a) Define the term *franchise*. *[2 marks]*

(b) Define the term *quality management*. *[2 marks]*

(c) Explain why quality management is important to a global franchise business such as Subway. *[4 marks]*

(d) Examine the potential problems of quality management as Subway continues its expansion plans. *[6 marks]*

Question 37.2 - Nissan's product recalls

In May 2013, Nissan recalled 841,000 cars worldwide due to **quality control** issues caused by faulty steering wheels, although no accidents were recorded. Nissan stated that each car would take 15 minutes to repair. Car manufacturers are continually striving to reduce their costs by using the same components across a range of models. This can help firms such as Nissan to gain from **economies of scale**, but it has also increased the number of product recalls (defects).

Earlier in 2013, Nissan recalled 500,000 vehicles due to faulty passenger airbags. Nissan's larger rival, Toyota, also recalled 885,000 vehicles in October 2013 due to an airbag defect and 1.9 million of its top-selling Prius hybrid cars in February 2014 due to a software fault.

Then, in 2017, Nissan recalled another 1.2 million passenger vehicles in Japan after discovering final vehicle inspections were not made. The cost of this product recall was around 25 billion yen ($222 million). Problems continued in 2021, when the rear seatback of the Nissan Juke did not securely lock when folded upright, causing 56,000 vehicles to be recalled for fixing.

(a) Define the term *quality control.* *[2 marks]*

(b) Define the term *economies of scale.* *[2 marks]*

(c) Examine how a major product recall can be costly to businesses such as Nissan. *[6 marks]*

5.3 Lean production and quality management (HL only)

Professor W. Edwards Deming (1900 - 1993), considered by many as the father of quality management, argued that QC methods are ineffective and costly. He suggested that quality comes from a system that *improves,* rather than *inspects*, the production process. Deming's philosophy for quality improvement is based around four key phases:

- *Plan* - Improve quality by designing or revising products, procedures and processes.
- *Do* - Execute the plan.
- *Check* - Monitor and measure the performance and assess the results.
- *Act* - Decide on any necessary changes that are needed to further improve the quality management process.

Quality assurance, as a major feature of total quality management (see section below), is an on-going process. Once a business has achieved a certain quality standard, its processes are regularly inspected by the respective awarding body to ensure that the standards and practices are being maintained. If quality standards are subsequently found to have dropped below the expected requirements, then the business will be stripped of its QA award or status. For example, a school can only offer the IB programmes if it is fully authorized by the International Baccalaureate (IB) as an 'IB World School'. This status is in recognition of the school having met the quality standards and practices set by the IB.

Whilst quality management can be costly to implement, it is important to recognize that it can be profitable in the long run. In fact, the lack of quality management can be extremely costly. There are no shortcuts to QA and businesses must spend some money (on quality management) in order to earn money.

Question 37.3 - McDonald's "100% Quality Food"

As part of its quality assurance, McDonald's "100% Quality Food" campaign informs customers that it believes in great-tasting food, based on only the best quality ingredients. In-store displays and literature support this claim by stating that:

- Only 100% beef is used without additives.
- Only prime white fish is used.
- Only chicken approved by the national authority responsible for ensuring food safety is used.
- Only the freshest eggs are used. Eggs are washed and sanitized to remove dirt from the shells.
- Only Russet Burbank potatoes are used to make French fries that are fluffy inside and crispy outside.



Lean production methods are also used at McDonald's to minimize waste, including all meals being made to order only.

Source: McDonald's in-store literature

(a) Define the term *quality assurance*. *[2 marks]*

(b) Define the term *waste*. *[2 marks]*

(c) Examine the importance of quality management for multinational companies such as McDonald's. *[6 marks]*

Given the importance that organizations attach to achieving a desired level of quality, it is essential to understand how businesses can measure quality. The most common methods include:

- *Reject rates* - This refers to the number of products that are not accepted for sale (as they do not meet the required quality standards) as a proportion of the total volume of output. The higher the reject rate, the lower quality assurance tends to be.
- *Level of product returns* - Faulty and substandard products are far more likely to be returned by disgruntled customers.
- *Product recalls* - Faulty products may need to be recalled (brought back for corrections) by the manufacturer to prevent a major public relations disaster (see Question 37.2).
- *Level of customer satisfaction* - Dissatisfied customers are more likely to complain about the quality of a product or a firm's services. By contrast, good quality leads to enhanced customer relations (validated by customer satisfaction surveys).
- *Degree of customer loyalty* - High quality output is more likely to encourage repeat purchases. This can be measured by customer retention levels or brand loyalty.
- *Market share* - Good quality is likely to earn a business greater market share as sales revenues and brand preference (see Chapter 27) both improve.

Exam tip !

The concept of quality can be somewhat subjective, i.e., what constitutes as 'quality' will depend on the product in question and personal opinions will vary from one individual to another. Furthermore, not all aspects of quality are easily measurable, such as the value of a brand or a firm's reputation. It is important to note that quality is continually evolving so can be expensive to implement. Hence, whilst quality is important to all businesses, it is necessary to ensure the benefits of quality assurance outweigh the implementation and maintenance costs in the long run.

Methods of managing quality

The following methods of managing quality: (i) quality circles, (ii) benchmarking and (iii) total quality management (TQM). AO2
The impact of lean production and TQM on an organization. AO3
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(i) Quality circles

Quality circles are small groups of employees who meet regularly to examine issues relating to the quality of output and make recommendations for improvement. The term was coined in 1962 by the University of Tokyo's Professor Kaoru Ishikawa (1915 - 1989). Members of a quality circle consist of volunteers from various departments, although it is common for a senior manager to chair the meetings. It is believed that such arrangements encourage communications and teamwork in order to solve problems that have a negative effect on quality in the workplace. Similar to Kaizen groups, quality circles are a vital part of quality management, emphasizing improvements through the involvement of staff. However, unlike Kaizen, members of quality circles are also directly involved in the execution and management of the recommendations or solutions.

Advocates of quality circles emphasize the importance of team cohesiveness in managing and improving quality. Businesses that fail to acknowledge the contributions of their staff often find a drop in the level of motivation and standards of work. Furthermore, such corporate cultures result in employees being only motivated by self-interest rather than feeling a sense of responsibility for the success of the organization. By contrast, businesses that adopt quality circles believe that there is always room for improvement, in all aspects of their operation and not just the production process. This includes investigating ways to improve marketing, human resource management and financial control. The ultimate impacts on the organization are increased efficiency, productivity and profitability.

A limitation to quality circles is that some individuals remain unmotivated by teamworking, extra responsibility or empowerment (see Chapter 10). These people prefer to be told what to do and see work as a means to an end, i.e., they perceive no loyalty to the organization and work primarily for the pay.

(ii) Benchmarking

Benchmarking or **Best Practice Benchmarking (BPB)**, refers to a business comparing its products, operations and performance with others in the same industry, especially market leaders. BPB then becomes a point of reference for the business

to target or emulate. The purpose is to allow the business to emulate best practice (excellence) in order to improve its own operational efficiency. For example, luxury car manufacturers might benchmark their products and processes against market leaders such as Mercedes-Benz, BMW and Audi. Box 37.3 outlines the various types of best practice benchmarking. The benefits and limitations of benchmarking are outline in Table 37.2.



Figure 37.6 - Benchmarking is intended to help improve performance

Box 37.3 - Types of benchmarking

- *Performance benchmarking* is used to benchmark the key performance indicators of a business, e.g., productivity and labour turnover rates (see Chapter 40).
- *Process benchmarking* is used to benchmark the processes and operations of a business, e.g., queuing times at restaurants, hotels or theme parks.
- *Internal benchmarking* involves benchmarking different operations or functions within the same organization, e.g., output or sales revenue per worker in different departments.
- *External benchmarking* involves benchmarking against products or organizations that are regarded as the best (market leaders) in the industry.
- *International benchmarking* is benchmarking against the performance of competitors in overseas markets.

There are two methods of best practice benchmarking:

- *Historical benchmarking* involves comparing the same performance indicators over time, e.g., sales turnover, market share, profits, staff turnover, productivity or defect rates. This is used for internal benchmarking purposes whereby the performance of the organization can be measured.
- *Inter-firm benchmarking* involves comparing the same performance indicators of different businesses. For example, Citibank might compare its staff turnover rate with other financial institutions such as HSBC, Standard Chartered and Bank of America.

Table 37.2 - The benefits and limitations of benchmarking

Benefits of benchmarking	Limitations of benchmarking
Benchmarking allows a business to reduce the performance gap with its rivals if BPB is successfully implemented.	The costs and time implications of collecting relevant and up-to-date information for BPB can be major issues.
Dealing with problems of quality by using external benchmarking is more effective than simple guesswork or intuition.	Matching the ideas and best practice of competitors is perhaps second best, without any distinctive selling points.
BPB looks at comparisons from the perception of customers and should therefore help the business to take appropriate action to meet the needs and wants of its customers.	The costs of implementing best practice can be very high. Sufficient time and finance must be made available to implement the findings from the ongoing benchmarking process.
The successful implementation of BPB can help a firm to improve its competitiveness and simultaneously lower unit costs of production due to efficiency gains.	Relying on BPB and ideas from others can discourage initiative in the workplace, thereby restricting creative, innovative and strategic thinking.

HIGHER LEVEL

ATL Activity 37.2 (Research skills) - JD Power

J.D. Power and Associates is a market research firm that provides global marketing information services. Founded in 1968, the American firm is best known for its customer satisfaction surveys. Visit www.jdpower.com to find out which car manufacturer has topped this year's chart for producing the best quality cars. What are the key performance indicators used to measure quality in the industry?

(iii) Total quality management (TQM)

Total quality management (TQM) is a philosophy and process that requires the dedication of everyone in an organization to commit to achieving quality standards. Quality is seen from the perspective of the customer rather than the producer. TQM removes wastage and inefficiencies in all forms of business activity (production, marketing, finance and personnel). Hence, this requires all employees to be appropriately trained and to be fully committed to checking and correcting their own work as appropriate.

As a philosophy that embeds quality management in every business operation and process, TQM only works if it becomes part of the organization's culture. TQM places quality as the core focus in all functional areas, i.e., every employee is responsible for quality assurance, rather than it being the traditional role of specialist quality controllers.

TQM empowers every employee to take corrective measures if quality is unacceptable (substandard). The purpose is to achieve zero defects in the organization (see Chapter 40). This means that all products, operations and processes are monitored and managed to ensure that they meet the required quality standards without any faults. If achieved, lean production and TQM will eliminate waste and the need to rectify mistakes. Ultimately, the long-term impacts are positive, leading to improved customer satisfaction and competitive advantages. Table 37.3 outlines the benefits and limitations of TQM.

Business Management Toolkit

Discuss the value of Porter's generic strategies (see Chapter 53) in relation to lean production methods used to increase productivity. How do these strategies (such as cost leadership and cost focus strategies) help to raise capacity utilization and reduce costs?

Table 37.3 - The benefits and limitations of total quality management (TQM)

Benefits of TQM	Limitations of TQM
Employee motivation is likely to improve since workers are empowered and involved in decision-making processes.	TQM can become quite bureaucratic as procedures and processes must be audited and administered properly.
TQM reduces or eliminates wastage (defective goods and re-working) as things are done right first time, thereby lowering unit costs of production.	There are costs in establishing and maintaining a TQM system, e.g., on-going costs of market research into customer satisfaction levels.
Gaining a reputation for TQM can help an organization to improve its corporate image.	Achieving TQM requires sufficient funding for staff training and development.
The needs and preferences of customers are a central focus of the production process, so TQM can help to give a business a competitive advantage.	TQM only works if every member of the organization, irrespective of their rank, is fully committed. This also means that managers must set an example for others.
TQM helps to improve the chances of business survival; poor quality is not sustainable.	There is usually a time lag (sometimes lasting several years) before the benefits of TQM materialise.

Question 37.4 - Mercedes-Benz

Mercedes-Benz is one of the most recognized brand names in the world. Rivals such as BMW and Audi often **benchmark** against the quality standards set by Mercedes-Benz. All new Mercedes-Benz cars come with between 1 to 3 years warranty, with the manufacturer undertaking any necessary work arising from any **defects**, free of charge. Top of the range high-performance Mercedes-Benz cars carry the 'AMG' badge as a sign of their superior build quality and performance.



(a) Define the term *benchmark*. *[2 marks]*

(b) Define the term *defects*. *[2 marks]*

(c) Discuss the extent to which benchmarking can help businesses such as Mercedes-Benz to achieve quality assurance. *[10 marks]*

National and international quality standards

The importance of national and international quality standards. AO2

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Quality standards refer to national and/or international benchmarks that enable certification of quality assurance. They are used to show that certain quality standards have been met, i.e., specific minimum quality standards that meet the needs and requirements of customers. Businesses that achieve or exceed these quality standards can include the quality award accreditation on their products and in their marketing communications. This helps to assure customers that the products are of high quality.

National and international quality standards are important because they help businesses to:

- communicate and promote awareness of quality within the organization
- improve organizational performance and operational efficiency
- recognize and reward quality achievements, thereby improving overall motivation of the workforce
- attract high calibre workers to the organization
- strengthen their competitiveness in domestic and oversea markets.

There are numerous organizations that promote and regulate product and service quality. They usually operate as autonomous bodies (independent of any government) to promote and recognize the quality performance of organizations. In order to obtain quality standard awards, products tend to undergo stringent and regular testing and assessment by independent agents. Only if a business has proved that its goods and services meet or exceed these standards is it given the quality award in recognition of its achievements.

Examples of national and international quality standards include:

- *The CE Mark* - This is the European Union's award for products that meet mandatory health and safety standards. 'CE' stands for Conformité Européenne, French for European Conformity.
- *The ASQ Award* - The American Society for Quality (ASQ) is an organization dedicated to the promotion and advancement of quality in the USA, with nearly 80,000 corporate members. It administers the prestigious Malcolm Baldrige National Quality Award which recognizes businesses that have achieved performance excellence. It is one of only two US Presidential awards given to businesses.

- *The BSI Kitemark* - The British Standards Institution (BSI) is the official organization responsible for setting quality standards in the UK. Products that carry the BSI Kitemark (see Question 37.5) help to inform customers that they have been manufactured to a high quality standard.

- *The Lion Mark* - This quality standard is awarded by the British Toy and Hobby Association (BTHA) for products that meet a strict code of practice on toy safety. It also assures customers that the product is genuine and not a counterfeit.

The most prominent global organization for quality assurance is the **International Organization for Standardization (ISO),** founded in 1947 and based in Geneva, Switzerland. It is made up of representatives from 163 national quality standards bodies, such as the ASQ and the BSI. The ISO's goal is to facilitate international trade by providing a single set of quality standards that consumers and businesses throughout the world would recognise and respect. The ISO is one of the most powerful non-governmental organizations (NGO) in the world as it is influential in affecting government legislation.

The most widely recognized ISO Standard for quality management is the "ISO 9000". It is awarded by independent auditors who certify that the ISO Standards have been met. The ISO then endorses that the business has:

- Monitored operations and processes to ensure that quality goods are being produced.
- Checked products for defects before they are distributed, having carried out corrective measures where necessary.
- Regularly reviewed its operations and processes to sustain or improve its efficiency.
- Proper record keeping.

Businesses that meet the ISO Standards can publicise their achievement by stating themselves to be "ISO 9000 certified" or "ISO 9000 registered." The ISO Standards apply to both manufactured goods and the provision of services.

Theory of Knowledge (TOK)

Does our understanding and knowledge of 'quality' stand the test of time?

ATL Activity 37.3 (Research and Thinking skills)

Visit the websites of the Council of International Schools (www.cois.org) and Western Association of Schools and Colleges (www.wascweb.org) to investigate the benefits to international schools and colleges that gain CIS-WASC accreditation. Be prepared to present your findings to the rest of the class.

ATL Activity 37.4 (Research and Thinking skills)

Investigate the national quality standards in your own country - or a country of your choice. Find out about the work of the organization(s) that is (are) in charge of regulating quality standards in this country. Consider the benefits to businesses being awarded such national quality standards.

Question 37.5 - The BSI Kitemark

The British Standards Institution (BSI) is the organization responsible for setting quality standards in the UK. Products that carry the BSI Kitemark reassure customers that the goods have been independently tested for quality and safety, so are fit for their purpose. According to the BSI, around 82% of British adults recognise the Kitemark as a sign of quality and safety. It also claims that 88% of the public believe that a Kitemark shows that the product comes from a reputable company, so they would be prepared to pay higher prices for such products.

Source: : Adapted from www.bsigroup.com

(a) Explain the role of a regulatory body, such as the BSI, in ensuring quality standards. *[4 marks]*

(b) Examine the advantages to organizations that have quality assurance certification, such as the BSI Kitemark. *[6 marks]*

Lean production, quality management and the key concepts

To achieve a culture within an organization that is committed to quality, all managers and employees must continually strive to improve all aspects of their working practices. Given ever-competitive markets that are frequently exposed to the forces of change in the external business environment, businesses need to focus on lean production and quality management being an on-going process that involves the continual updating and improvement of an organization's products, functions and processes.

There is also the argument that businesses are ethically or morally obliged to ensure products are safe to use, so must meet minimum quality standards. As famously declared by Aldo Gucci, chairman of luxury brand Gucci from 1953 to 1986, "*Quality is remembered long after the price is forgotten.*" Hence, lean production and quality management can affect the reputation of an organization. This is particularly applicable for service sector organizations such as air travel carriers, health care providers and theme park operators where customer safety has to be given top priority. For example, Hong Kong Disneyland has a specialist team of over 120 technicians who inspect, repair and maintain all the rides at the theme park on a daily basis. Hence, lean production and quality management directly affect the success and profitability of a business.

Every aspect of business activity can be continually improved (Kaizen). The emphasis on business ethics in an ever-competitive environment, in both domestic and international markets, leaves no room for error. Hence, quality management requires all internal stakeholders to be dedicated to this total quality culture and philosophy. Businesses can do this through motivational methods (see Chapter 10), developing multi-skilled workers and using creative and flexible working structures (see Chapter 8).

A lean and efficient business with a highly trained, creative and motivated workforce is more likely to achieve total quality management. This will also enable the organization to be more effective in responding to market changes. Furthermore, organizational change is easier to manage when there are small and continuous improvements, rather than one-off and with radical changes made.

Quality management is also a crucial aspect of sustainability. The growing demand for the earth's scarce resources and the growing importance of circular business models (see Chapter 51) mean lean production and quality management are more paramount to sustainable business practices than ever before. Hence, focusing on sustainable production processes can be important for retaining and building customer loyalty.

Nevertheless, the costs of implementing lean production and quality management can be very high, such as the costs of upgrading to the latest capital equipment and/or the costs of upskilling employees in order to achieve greater levels of efficiency. As with any decision, the benefits need to outweigh the costs in order for the business to remain operational in a sustainable way. From a quantity management perspective, however, perhaps the costs of *not* meeting lean production and quality standards are even greater to a business, particularly in the long run.

Theory of Knowledge (TOK)

Does the meaning of 'quality' apply across different cultures?

Key concept

With reference to an organization of your choice, examine how quality management is influenced by **change.**

REVIEW QUESTIONS

1. What is meant by lean production?
2. What is waste?
3. What is meant by Kaizen?
4. How is just-in-time a method of lean production?
5. What is cradle to cradle design and manufacturing?
6. What is meant by the term quality?
7. What is meant by a substandard product?
8. How does quality assurance differ from quality control?

9. What are the advantages and disadvantages of quality control?
10. What is quality assurance?
11. What are quality circles?
12. What is meant by benchmarking?
13. What are the benefits and limitations of benchmarking?
14. What is total quality management (TQM)?
15. What is meant by national and international quality standards?

KEY TERMS

Benchmarking is the process of identifying best practice in an industry, in relation to products, processes and operations. It sets the standards for firms to emulate.

Cradle to cradle (C2C) refers to a sustainable model of production based on natural processes, thus benefiting the environment. The underlying principle of C2C is that there is no waste in nature, making it sustainable.

Efficiency means using resources more productively, in order to generate more output in a cost-effective way.

ISO 9000 is the world's most widely recognised standard for quality management. It is endorsed by the ISO to firms that use quality management systems to meet the needs of customers.

Just-in-time (JIT) is an inventory management system based on stocks being delivered as and when they are needed in the production process.

Kaizen is the Japanese term for 'continuous improvement', a lean production philosophy that requires workers and managers to continually try to find ways to improve work processes and efficiency.

Lean production is the process of streamlining operations and processes to reduce all forms of waste and to achieve greater operational efficiency.

Quality means that a product fulfils its purpose and meets the expectations of the consumer.

Quality assurance (QA) is the management process of guaranteeing (assuring) that products meet certain quality standards, such as the ISO 9000 by making sure everything is done right first time and there are no defects.

Quality circles are small groups of employees who meet regularly to examine issues relating to the quality of output and make recommendations for improvement.

Quality control (QC) is the traditional approach to quality management that involves inspecting, testing and sampling the quality of work.

Quality management is the function concerned with controlling business activities to ensure that products are fit for their purpose.

Quality standards refer to national and/or international benchmarks that enable certification of quality assurance. They are used to show that certain quality standards have been met.

Substandard means that products do not meet the needs or expectations of customers, producers or governments due to their poor quality.

Total quality management (TQM) is a philosophy and process that requires the dedication of everyone in an organization to commit to achieving quality standards.

Waste refers to anything that prevents an organization from being efficient or lean, e.g., product defects, stockpiling and overproduction.

Chapter 38
Unit 5.4 - Location

"Man cannot discover new oceans unless he has the courage to lose sight of the shore."
- Andre Gide (1869 - 1951), French author and Nobel Prize Winner for Literature (1947)

Contents

5.4 Location	
SL/HL content	**Depth of teaching**
The reasons for a specific location of production	AO2
The following ways of re-organizing production, both nationally and internationally: • Outsourcing/subcontracting • Offshoring • Insourcing • Reshoring	AO3

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The location of production

The reasons for a specific location of production. AO2

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All businesses need to be located somewhere. Sole traders might operate from a room in their own home, wholesalers operate from large warehouses often in out-of-town areas, whilst large multinational companies are located throughout the world. Online businesses still need a physical location where they operate. Managers have a crucial role in weighing up the costs and benefits of a specific location. In the property (real estate) industry, the three rules to business success are simply location, location and location! Although somewhat of an over-generalisation, there is a large degree of accuracy to this saying.

Location refers to the geographical position of a business, i.e., where it is sited. The location decision depends on many factors such as the nature of the business (e.g., retail outlet or oil extraction), the nature of the product (e.g., agricultural products or tourism) and the nature of human resources (e.g., skilled or unskilled labour).

Box 38.1 - Did you know that…?

- Badminton was named after the place where the sport was invented - in Badminton, UK
- Brussels Sprouts were first farmed in Brussels, Belgium in the 13th Century
- Buffalo Wings were invented in 1964 in Buffalo, New York
- Champagne is named after the place where the sparkling wine was invented, in France
- Cheddar Cheese got its name from the town of origin in Cheddar, England
- Denim is named after de Nîmes, in southern France
- 'Geysers' comes from Geysir, Iceland
- Hamburgers got their inspiration from Hamburg, Germany where meat from Hamburg cows were minced to create beef patties
- 'Italic' means 'Of Italy', as the style of handwriting was invented by Italian printer Aldus Manutius in 1501



Geysers are a natural spectacle, caused by the shooting of hot spring water through a vent in the earth

Location decisions will occur in different situations. New businesses need to consider the location of their first premises. Businesses that plan to expand, domestically and internationally, also have to choose between different locations. The relocation decision occurs when managers consider moving to alternative premises, perhaps because of uncompetitive or unaffordable rents.

The location decision is one of the most important decisions that senior managers have to make, especially as it is often an irreversible decision, i.e., they cannot simply afford to relocate if things do not work out as planned. Even if relocation is possible, the costs of doing so can be extremely high. For many new businesses, the location decision incurs a highly significant proportion of their costs. It is unlikely that most of these costs can be recovered (known as sunk costs) if the business is unsuccessful. Hence, the location decision can have profound implications on the profitability and survival of a business. The decision is so important that it is classed as a long-term strategic goal and the decision is only made by entrepreneurs or the board of directors.



Figure 38.1 - Location is a major decision for all businesses

Quantitative reasons for a specific location of production

Quantitative reasons are those that can be numerically calculated, such as the cost of purchasing or renting commercial premises. The finance department and senior managers will be keen to look at the financial costs and benefits of locating or relocating the organization. Quantitative factors include the following: (i) availability, suitability and cost of land, (ii) availability, quality and cost of labour, (iii) proximity to the market (customers), (iv) proximity and access to raw materials, (v) government incentives and limitations and (vi) the feasibility of e-commerce.

(i) Availability, suitability and cost of land

The quantity, quality and cost of land are important factors when choosing a location. Decision makers consider the cost of land with earning potential; the busier the area, the higher the earning potential but the greater the cost of land tends to be. As rent forms a large proportion of fixed costs for most businesses (see Chapter 38), the high cost of land may reduce profits. However, the cheapest location is not necessarily ideal - perhaps the location lacks passing trade or the premises are in need of attention.

There are two main reasons why the cost of land is higher in city centres than elsewhere. First, there is more *demand* for land in city centres, largely due to the convenience it provides for customers, suppliers and employees. Second, the *supply* of land is very limited in these areas. The combination of high demand and low supply means that property prices and rents are higher in popular cities. It is no wonder then that the 37 million people who reside in Tokyo (the most populated capital city on the planet) make it one of the world's most expensive locations.

For some businesses, the suitability of land must also be considered. Agricultural businesses need to locate in areas with arable land and suitable climate. Businesses that are engaged in the production of dangerous products or harmful by-products need to locate away from highly populated areas.



Figure 38.2 - Property prices and rents are higher in popular cities such as Tokyo, Japan

Some organizations, such as hypermarkets or vehicle manufacturers need access to affordable land simply because they need so much of it. Hence, these businesses tend to locate away from central business districts where land is both scarce and expensive. Provided that there is adequate infrastructure, such as communication and road networks, this should not be a problem as such businesses do not need to locate near their customers. Instead, motor vehicles are distributed to showrooms and franchised dealerships that sell the vehicles. Hypermarket customers tend to drive out of city centres to do their shopping.

Question 38.1 - Location, Location, Location!

Growing demand from financial institutions and other businesses has raised land and property prices in central business districts throughout the world. The world's most expensive places to rent office spaces include London, Zürich, San Francisco, New York City, Sydney, Tokyo and Hong Kong. Prime office rents have also been surging in Moscow, Paris, Wellington, Dublin, Dubai and Abu Dhabi.



The Burj Al Arab in Dubai, UAE, has been dubbed as "the world's only 'seven-star' hotel"

(a) Outline how rising demand for land can push up its price. *[2 marks]*

(b) Explain **two** advantages for businesses considering relocating overseas. *[4 marks]*

(c) Explain **two** disadvantages for businesses considering relocating overseas. *[4 marks]*

The availability, suitability and cost of land also apply on a global scale. The opportunities found in lower-cost locations abroad have led to many businesses moving their operations overseas. Audi, Phillips and Coca-Cola are just some examples of manufacturers that have relocated to less affluent countries, largely due to the lower cost of land and labour - a highly important consideration for large companies that require a vast amount of space.

(ii) Availability, quality and cost of labour

The availability and quality of labour affect the level of wages and salaries paid to workers, so are therefore critical to any location decision. Tenneco, an American multinational manufacturer of exhaust pipes for General Motors, Volkswagen and Peugeot, chose to locate in Suzhou (China) and Kecskemét (Hungary) largely due to the high supply and low cost of labour. A study carried out by Fortune magazine found that labour accounted for just 1% of production costs in China's Tenneco plant. By contrast, other manufacturers such as Ferrari or Boeing need highly trained workers, who are well remunerated.

The supply and quality of labour varies even within a country, affected by factors such as the reputation of local schools and colleges, socio-economic demographics and regional unemployment rates. The inequality is much greater on an international scale. Firms requiring highly skilled engineers might locate in Germany where there is a readily available supply of suitably qualified and experienced labour. Likewise, businesses wanting to locate in Norway, Japan, Denmark and Finland should consider the high cost of living when remunerating their workforce in these countries. By contrast, mass market manufacturers, such as Nike, can locate in highly populated countries, such as Indonesia or Vietnam, where there is an abundance of labour at a relatively low cost.

(iii) Proximity to the market (customers)

Certain products such as bottled water or alcohol will increase in weight during the production process. These are known as **bulk-increasing** or **weight-gaining industries**, commonly found in businesses that assemble components. If they were to locate near the source of the raw materials, such as lakes and mines, this would increase their transportation costs when the final, heavier and bulkier product needs to be delivered. Hence, it makes more sense for these businesses to locate nearer to their markets. Examples include soft drink bottling manufacturers and fabricated metals producers.

In the manufacturing sector, firms that rely on just-in-time production (see Chapter 37) need to locate near their suppliers. This reduces transportation costs and time, thereby minimising delays in the delivery of products to customers.

In the tertiary sector, proximity to the market can also be vital. In retailing and service industries, customers demand convenience, so it is important for businesses such as hotels, restaurants and hair salons to be suitably located near their markets.



Figure 38.3 - Sole traders generally need to be located near their customers

(iv) Proximity and access to raw materials

The nearness to and availability of raw materials is a major determinant of location for firms operating in primary and manufacturing industries. **Bulk-reducing businesses** (or **weight-losing industries**) locate near the source of raw materials that are heavier and costlier to transport than the final product, i.e., the weight or size of the finished product is less than that of the raw materials used to produce it. For example, it is cheaper to extract steel, iron, sugar and oil at source than to transport these to other manufacturing sites because of the sheer weight and the high amount of waste or by-products from the raw materials.



Figure 38.4 - Mining is a bulk-reducing industry

(v) Government incentives and regulations

Governments often try to attract businesses to locate in or relocate to a certain area by offering financial incentives, such as tax allowances, grants and subsidies to help reduce their costs of production. Low or interest-free loans may also be offered by governments to encourage businesses to invest in a particular location. Such financial incentives are more likely to be approved if businesses locate in *assisted areas* or *special enterprise zones* (areas suffering from high unemployment, low incomes and/or undergoing economic regeneration).

On the other hand, governments can also impose regulatory limits that affect business location. For example, a business might find it more difficult to obtain a license to trade overseas than within the domestic country. Planning permission for extensions or modifications to a site might be a further problem and therefore affects the choice of business location. Corporation tax rates can also have large implications on the international location decision. According to the Tax Foundation, for example, Puerto Rico has a corporate tax rate of 37.5% whereas Barbados only charges 5.5% for its corporate tax rate.

Question 38.2 - Doing business in Singapore

Singapore has been consistently rated very highly in the World Bank's annual "Ease of Doing Business" report. The report ranks 178 economies in terms of regulations that either enhance or constrain business activity. Such regulations include starting a business, obtaining licenses, employing workers, registering property and investor protection.

Singapore is often ranked the top country in the world to do business due to its simplistic business procedures. For example, it only takes six days to start a business in Singapore, whereas it takes 141 days in Venezuela and 694 days in Suriname! Singapore is also a global manufacturing hub and a regional financial centre. However, Singapore is also one of the world's most expensive places to live, according to the Economist Intelligence Unit



Source: adapted from The World Bank (www.doingbusiness.org) and Economist Intelligence Unit (www.eiu.com)

(a) Explain **one** way in which government rules and regulations can constrain and **one** way in which they can enhance business activity. *[4 marks]*

(b) Examine **two** quantitative factors that businesses may need to consider before deciding whether to locate in highly rated countries such as Singapore. *[6 marks]*

(vi) Feasibility of e-commerce

E-commerce (electronic commerce) can have a huge impact on reducing the financial costs of location. Many businesses no longer need to be located near their customers as they are able to sell products via the Internet. For example, insurance companies, book retailers and music distributors can be located anywhere in the world yet still reach a global audience.

However, having a virtual business (e-business) rather than a physical presence (retailer) is not feasible for all organizations. For example, aircraft from Airbus or Boeing would not be purchased online. Instead, the manufacturers can use their websites to market their products, but the actual purchase is done through other means. Similarly, convenience stores such as 7-Eleven, Circle K, FamilyMart and Tesco Express all need to be located near their markets. These businesses often locate in busy commercial and residential districts.

Qualitative reasons for a specific location of production

Qualitative factors deal with the psychological and emotional aspects of location or relocation, such as familiarity with a particular area or consideration for the welfare of workers in the local community. Qualitative factors are not easy to measure, if measurable at all, but they can be just as important as quantitative factors when deciding where to locate a business. These factors include: (i) management preferences, (ii) local knowledge, (iii) infrastructure, (iv) political stability, (v) government restrictions and regulations, (vi) ethical issues and (vii) comparative shopping (clustering).

(i) Management preferences

Managers may prefer a certain location due to personal reasons, familiarity, gut feelings (instinct) or because they feel that the location will serve workers and the local community better. The headquarters of the Body Shop is in Littlehampton (UK) simply because the founder, Anita Roddick, was born and grew up there. For Roddick, there was an emotional attachment to the area rather than basing her location decision on quantitative reasoning.

Managers may also prefer a certain location because of its history. Hollywood movie director Oliver Stone had little to think about when choosing New York as the location for filming '*The World Trade Centre*', based on the tragic events of the 11th of September 2001.

Theory of Knowledge (TOK)

How useful is intuition as a basis for making knowledge claims in Business Management?

(ii) Local knowledge

Similarly, businesses may locate in a certain area because they know the location and its culture. This inside information makes it easier and less risky for a business to establish itself, thereby giving it a potential competitive advantage. Hofstede's cultural dimensions (see Chapter 54) suggests that multinationals must consider the cultural differences that exist throughout the world. A lack of local knowledge and cultural sensitivity can prove disastrous.

For example, the launch of OK! magazine in the USA was, at that time, the world's largest magazine launch (as measured by advertising and publishing expenditure) but sales were a disaster because the UK firm did not realise that US supermarket shelf sizes were too small to hold the oversized magazine! Similarly, the Sock Shop went for a huge-scale launch in Florida (nicknamed the Sunshine State) and found sales were disappointing as the hotter climate limited the sale of socks.

(iii) Infrastructure

This is perhaps the most common qualitative factor affecting the location decision. Infrastructure is the term used to describe transportation, communication and support networks in a particular area, region or country:

- *Transportation networks* include links to roads, rail, sea and air. The most appropriate transportation network for a business depends on its size and the products that it sells. For example, courier companies such as UPS, DHL and FedEx will want to be located in areas with good road and air networks.

- *Communication networks* covers access to telephone lines (for telecommunications coverage and Internet services) and postal services.

- *Support networks* refers to the back-up (maintenance) and related services that are essential for the running of a business, such as utilities companies to provide fuel, water, power and waste management.

The government is responsible for the economy's infrastructure. Not only does the infrastructure affect the location of businesses, but it also influences a country's international competitiveness. For example, large multinational companies may be reluctant to locate in a host country if it has inadequate or outdated infrastructure. Businesses prefer to locate in areas with good infrastructure so that they can supply goods and services more efficiently and more cost effectively to their customers. Manufacturers and distributors need easy access to rail, port and road networks. Although e-commerce has enabled the likes of Taobao, Amazon and e-Bay to be located almost anywhere, online retailers still need easy access to transportation networks to ensure that deliveries are made swiftly. Therefore, having good infrastructural networks helps to increase national output and reduces costs of production, thereby improving the country's international competitiveness.

Infrastructure is also important to ensure that employees can get to and from work without too much inconvenience. Location can therefore have an impact on recruitment, retention and motivation of staff. For example, people who work at out-of-town theme parks or at the airport often have their travel expenses subsidised. This helps to compensate for the cost and time involved in traveling to these places of work. However, this also means an increase in the organization's costs.



Figure 38.5 - Poor infrastructure limits incentives to locate in a particular location

(iv) Political stability

Even if monetary-related factors are favourable in a particular location, managers may still need to consider the political stability of the country that they wish to locate in. A stable political environment helps a business to trade effectively, thereby reducing the risks of operating overseas. Countries that can offer political harmony, free from corruption, a good law and order system, a stable exchange rate system and low rates of taxation will tend to be more attractive to multinational businesses.

Reports by the World Bank show that Congo is one of the worst places to conduct business. This is largely attributed to corrupt government activities, the nation's huge rates of taxes and poor infrastructure. In some cases, political instability can cause anti-government protests or even riot, which can cause major disruptions to any economy.

(v) Government restrictions and regulations

Businesses also need to consider government policies and regulations that constrain business activity as administrative and bureaucratic processes vary from country to country. For example, it takes just 2 days to register a company in Canada and Australia, whereas it takes an average of 8 days in France, 152 days in Brazil and a tedious 203 days in Haiti. The difficulty in obtaining licenses, permits, copyrights and planning permission may lead to businesses looking to locate in alternative countries.

The Heritage Foundation, a research organization based in the USA, publishes an annual 'Index of Economic Freedom' which ranks the attractiveness of economies based on how government intervention can restrict or aid economic relations and business activity. The annual survey ranks the freedom (or ease) to do business in different countries based on criteria such as economic freedom, political freedom, measures of anti-corruption and fiscal freedom (tax rates). Singapore, Australia, New Zealand and Switzerland regularly rank at the top of the Heritage Foundation's league tables.



Figure 38.6 - Australia ranks high in The Heritage Foundation's Index of Economic Freedom

Question 38.3 - Doing business in India

Deregulation of markets in India has allowed foreign retailers to own their own stores in the country. Before the liberalization of trade, foreign business activity was heavily regulated as a way of protecting domestic jobs and businesses. The change presents many investment opportunities for multinational companies such as Nike, BMW, PepsiCo and Marks & Spencer.

India is opening up to western cultures and has huge market potential for businesses. For example, foreign firms will have a larger role in supporting the rapid development of the country's retail, tourism and aviation industries.

However, India's bureaucratic procedures for international trade mean that doing business in India has its problems. Corruption is also an ongoing problem in India. Transparency International, a global non-governmental organization, claims that there is a strong correlation between corruption, poverty and competitiveness, i.e., higher levels of corruption in a country jeopardise a nation's ability to alleviate poverty and to be competitive on an international level.

(a) Explain **two** risks involved for multinational companies, such as Nike, BMW, PepsiCo and Marks & Spencer, wishing to invest in India. *[4 marks]*

(b) Examine the opportunities that might exist for businesses that plan to invest in economically developing countries such as India. *[6 marks]*

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(vi) Ethical issues

Decisions regarding the international location or relocation of a business often include an ethical dimension. For example, a business that exerts lots of waste, noise and pollution might choose to locate in out-of-town and remote areas to avoid complaints from the local community. It may also be seen as unethical for a business to relocate if this will cause major job losses in a certain area, thereby potentially damaging the firm's reputation, sales and profitability.

(vii) Comparative shopping (Clustering)

Clustering means that firms locate near other businesses that cater for similar or complementary markets. For example, London's Savile Row is internationally renowned for its bespoke (custom made-to-measure) suits for men and women. The main clientele of businesses located on Savile Row are the rich and famous. According to Business Week, the average suit takes 12 weeks to make and is priced at £3,755 ($5,450) from any of the numerous specialist tailors on the street.



Figure 38.7 - London's Savile Row is known across the world for its bespoke suits

Similarly, retailers of computer hardware and mobile phones tend to locate near one another to make the most of the passing trade. Fast food chains locate in busy shopping malls to take advantage of people who need to eat and drink whilst at the mall. Accountancy and law firms also locate close to each other whilst shoes and clothes retailers locate near one another to benefit from the complementary goods and services provided in the same area.

Question 38.4 - Fifth Avenue, New York

Retail space in New York's Fifth Avenue has one of the highest rental values on earth and is known by locals as the "most expensive street in the world". The exceptionally high price of leasing land has been accelerated by the world's top brands competing to secure key spots in this prime location. Other highly sought-after retail locations include Ginza in Tokyo, Oxford Street in London and Avenue des Champs Elysees in Paris.



Fifth Avenue, Manhattan, New York City, USA

(a) Explain why location is an important management decision for retail businesses. *[4 marks]*

(b) Examine why retail businesses might be prepared to pay exceptionally high rents in prime locations such as Fifth Avenue. *[6 marks]*

Exam tip !

In reality, organizations consider a combination of quantitative and qualitative factors when considering the attractiveness and suitability of business locations. This applies to domestic and overseas locations and relocations. As always, it is vital to consider these factors in the context of the business you are looking at, e.g., different stakeholder groups may have different views about the best choice of location.

Ways of reorganizing production

The following ways of reorganizing production, both nationally and internationally: (i) outsourcing/subcontracting, (ii) offshoring, (iii) insourcing and (iv) reshoring. AO3

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(i) Outsourcing/subcontracting (AO3)

Outsourcing is a way of reorganizing production, both nationally and internationally. **Outsourcing** (or **subcontracting**) is the practice of transferring internal business activities to an external organization in order to reduce costs and increase productivity. **Subcontractors** are outsourced firms that undertake non-core activities for an organization. They are used for their expertise and the cost advantages they bring, i.e., they can carry out the outsourced work more cost-effectively without compromising quality. Typical operations that are outsourced include recruitment, office cleaning, accounting, property management, call centres, customer support services, security systems and ICT maintenance.



Figure 38.8 - Security services are often outsourced

Table 38.1 - The advantages and disadvantages of outsourcing

Advantages of outsourcing	Disadvantages of outsourcing
Specialists are hired to carry out the work to high quality standards. This is particularly important if the business does not have the necessary skills and expertise available internally to carry out the outsourced functions.	In their aim to cut costs, subcontractors have been known to 'cut corners' by hiring under-aged, illegal and unqualified workers. This has led to substandard quality and conflict between the contractor and subcontractor.
Different subcontractors will bid (or tender) for the outsourced work. The one with the most attractive overall package will be awarded the contract. This means that the outsourced work is provided at competitive rates, enabling the business to control its own costs without jeopardising quality.	Quality management can become more challenging. Subcontractors are relied upon for the quality of the outsourced work. Allowing external entities to have such a large influence on the reputation of a business is risky and can be potentially disastrous.
It helps to reduce labour costs as outsourced workers are not employees of the organization, e.g., they are not remunerated with holiday pay, bonuses, sick leave or pension contributions.	Subcontractors need to be monitored to ensure that deadlines are met and quality standards are observed. This will increase the costs of administering all outsourced activities.
Outsourcing allows the business to concentrate on its core activities, i.e., what it is best at doing. This can therefore help to improve the overall efficiency of the organization.	Outsourcing can initially cause redundancies in the organization. This needs to be managed carefully as it will affect the level of staff morale and motivation within the firm.
Outsourcing improves workforce flexibility. For example, there is no need to recruit employees during busier trading periods as subcontractors can be used to increase output. Conversely, during less busy times, there is no need to reduce staffing as the outsourced firm is responsible for this.	Outsourcing has often been associated with unethical practices, such as the exploitation of labour in less economically developed countries. This often includes poor working conditions, long working hours, low pay and an absence of health and safety policies.

(ii) Offshoring

A second way of reorganizing production is offshoring. **Offshoring** is an extension of outsourcing, which involves relocating business functions and processes overseas. There are two categories of offshoring: *production offshoring* (manufacturing) and *services offshoring* (such as call centres). These often take place in low-income countries where labour costs are low. This means that offshored functions can remain within the business (operating overseas) or outsourced to an overseas organization. In the latter case, this is known as **offshore outsourcing**. For example, Apple and Xiaomi use offshore outsourcing for the production of their smartphones, using Foxconn as the subcontractor. Nintendo, Sony and Microsoft also outsource the production of their game consoles to Foxconn. In addition to manufacturing, other typically offshored functions or services include telesales, call centres, research and development (R&D) and accounting services.

American and British firms dominate the practice of offshore outsourcing. This has made countries such as India and the Philippines highly attractive locations due to their large pool of educated English-speaking workers who earn significantly less than their western counterparts. For example, popular outsourced activities in the Philippines include call centres, financial management, computer software development and legal transcriptions. New Balance, Puma and Reebok outsource the production of their footwear to China's Yue Yuen Industrial Holdings, the world's largest manufacturer of sports shoes.



Figure 38.9 - Offshore outsourcing is popular among sports shoes manufacturers

Offshore outsourcing can help a business to get around protectionist measures used by foreign governments (see Chapter 46). For example, Nike and Adidas outsource the manufacturing of their sports apparel to firms in China, Vietnam and Indonesia. This helps them to get around the

problem of import taxes and other trade restrictions being imposed on the sale of their products in these countries. It also allows the companies to access the latest technologies and developments in manufacturing activities that they do not have any expertise in.

However, critics of offshoring have complained about quality management issues. For example, can someone in a call centre in India or the Philippines really address 'local' banking issues from clients in London, Paris or New York? A survey report in The Scotsman revealed that almost 15% of businesses surveyed had or were switching production back to the UK because output was falling below the expected quality standards.

The benefits of offshoring are also subject to changes in the external environment (see Chapter 46). For example, the cost savings from offshoring may be wiped out simply because of adverse fluctuations in the exchange rate. Similarly, if the host country experiences high rates of inflation and frequent rises in minimum wages, then the business may need to reconsider the use of offshoring.

The advantages of outsourcing also apply to offshoring. Findings from Forrester Research Inc., an American research and consulting company, show the number of US jobs offshored each year is around 300,000. The top reason for this is the lower costs of labour in overseas markets. For example, the minimum wages per hour in Australia ($14.43), Luxembourg ($13.67) and New Zealand ($13.18) are significantly higher than in Turkey ($1.93) and Mexico ($1.05).

Offshore outsourcing can also help businesses to avoid trade protectionist measures used by governments, such as tariffs and quotas (see Box 46.3). For example, Nissan has four offshore production facilities in Spain (Barcelona, Montcada, Ávila and Cantabria). This helps the Japanese carmaker to avoid protectionist measures set by the European Union, such as tariffs (import taxes) imposed on the sale of Nissan cars imported from outside of the EU.

However, offshoring has often been associated with unethical practices, such as the exploitation of labour in low-income countries including poor working conditions, low pay, the use of child labour and poor health and safety policies. Quality assurance therefore becomes more challenging.

Offshoring can also be vulnerable to external influences such as economic and political instability. For example, countries that face major political unrest will have negative impacts on businesses with offshored activities in these countries. The unemployment rate in Greece exceeded 13% in 2021, with the youth unemployment rate (for those aged under 25 without a job) having reached 39.1%. This would clearly have major consequences for businesses operating in Greece at the time.

Offshoring has brought about many benefits for host countries, such as job creation and relatively higher wages compared with wages paid by local firms. China and Vietnam have proved to be popular locations for production offshoring whilst India has emerged as a magnet for services offshoring.



Figure 38.10 - Vietnam is a popular choice for offshoring

Exam tip !

Be sure you can explain the differences between outsourcing, offshoring and offshore outsourcing:

- Outsourcing refers to the use of a third-party contractor paid to carry out specific work.
- Offshoring refers to getting business activities or functions done in a different country, usually due to cost advantages of locating overseas.
- Offshore outsourcing is the hiring of a contractor to do the work overseas, usually to lower costs and to take advantage of the vendor's local expertise.

Question 38.5 - Jeffrey Penn School

Jeffrey Penn School in Southwark, southeast London, became the first school in the UK to **outsource** its teaching to India. Staff located more than 4,000 miles away are being paid to teach children struggling in mathematics. The service, provided by Brighter Education, costs £12 ($17) an hour for each student, which is significantly cheaper than employing private tutors at a cost of £40 ($56) an hour. The service involves students using Brighter Education's online platform to complete their work on the computer. They can also talk live with a teacher in India using this platform.

Jeffrey Penn School was approached by Brighter Education to pilot the system. The school claimed that the service had made a considerable improvement to student learning in mathematics, but critics argued the move would undermine teaching standards. They suggested that quality assurance could be an issue, depending on the quality of the tutor's English proficiency and cultural awareness. Brighter Education said that all its tutors are graduates of mathematics with relevant teaching experience.

(a) Define the term *outsource.* *[2 marks]*

(b) Evaluate the decision of Jeffrey Penn School to outsource some of its teaching to tutors in India. *[10 marks]*

Question 38.6 - Volkswagen

Volkswagen Group, the German car manufacturer and owner of **brands** such as Audi, Bentley, Bugatti and Lamborghini, were given permission in 2006 to build a car plant in Punjab, India. Despite India's underdeveloped **infrastructure**, Volkswagen announced that it was to invest about 15 billion rupees ($340m) in the plant, creating 5,000 jobs. In addition, there would be around 50,000 jobs created indirectly. Other car manufacturers also have a presence in India, such as Mercedes Benz (since 1983) and BMW (since 2007). Analysts expect car sales in India to carry on booming as the world's second most populous country continues to enjoy steady economic growth.



(a) Define the term *brands.* *[2 marks]*

(b) Define the term *infrastructure.* *[2 marks]*

(c) Evaluate the decision of Volkswagen to offshore production in India. *[10 marks]*

Question 38.7 - Offshoring in India

Indian software firms have benefited from the influx of European and American companies that have been **offshoring** their operations in order to cut costs. For instance, Bangalore-based Wipro, a multinational conglomerate, offers services in ICT, software development and call centre services to foreign customers such as Cisco Systems. Foreign companies are attracted by the relatively low wage costs and the abundant supply of skilled labour in India. British and American companies are also attracted by India's large English-speaking workforce.

(a) Define the term *offshoring*. *[2 marks]*

(b) Evaluate the reasons for and against businesses choosing to offshore some of their functions to external organizations located overseas. *[10 marks]*

(iii) Insourcing (AO3)

Insourcing is a third way of reorganizing production. **Insourcing** is the use of an organization's own people and resources to accomplish a certain function or task, which would otherwise have been outsourced. There are two main reasons for insourcing to occur:

- The business had previously outsourced a particular function or role but is no longer satisfied with the quality of work being done. The task is then assigned to someone in-house with the intention of improved results.
- There are no longer cost-saving benefits from using a subcontractor and the function or task can be assigned to people in-house in order to cut costs.

Although outsourcing is commonly used by multinational companies to reduce costs, it is sometimes more cost-effective to use insourcing if the work can be done more efficiently and to a higher quality standard in-house. At times, businesses may also need to consider re-shoring (bringing back operations from overseas). This might be due to rising labour costs abroad and/or higher rents being demanded.

However, there are problems with relocation (see Box 38.2) so there is often a reluctance from managers to relocate. This notion is known as industrial inertia. The term was coined by Allan Rogers (1952) who found that American steel producers tended to continue to invest and reinvest in an existing location, even when the competitive advantages for the location no longer existed. It happens as managers may feel that the potential inconveniences and costs of relocation outweigh the benefits.

Box 38.2 - Potential limitations of relocation

- Relocation costs, e.g., transportation, insurance and legal fees.
- Lower morale and higher anxiety caused to the workforce.
- Damage to the corporate image if the firm is seen to value profits over its people.
- Loss of skilled and loyal (but geographically immobile) workers.
- The likely need to find new customers and suppliers.
- Strong links with the existing local community will be lost.
- Redundancy payments made to retrenched workers.

(iv) Reshoring

The fourth and final way of reorganizing production specified in the syllabus is reshoring. **Reshoring** is the reverse of offshoring, i.e., the transfer of business operations back to their country of origin. Reshoring has become more popular as the cost-effectiveness of offshoring has declined for many companies. For example, US toy firm Wham-O reshored production of its highly popular *Frisbee* (flying disc toy) from China to California in 2010. Toyota pulled out of Australia in 2017,

citing rising costs of production largely caused by the strength of the Australian dollar. According to Reshoring Initiative, the US reshored 1,057,054 manufacturing jobs between 2010 and 2020.

Reasons for reshoring include:

- Product recalls and mass-media coverage of outsourced business practices that are unethical have caused concerns for multinational companies (MNCs). Improving and monitoring the quality and consistency of output is perhaps easier if production is reshored.
- Transportation costs continually rising mean that is has become more cost effective for businesses to be located nearer to their customers. Disruptions to supply chains caused by the prolonged COVID-19 pandemic have resulted in widespread and lengthy delays to production and distribution of goods and services across the world.
- Domestic governments have also supported and encouraged reshoring, in order to bring back jobs to the domestic country and reducing unemployment in the domestic economy. This was particularly important following the aftermath of the global financial crisis of 2008 and the more recent coronavirus pandemic.

However, as with any strategy, reshoring does not always work. Many businesses that choose the reshoring route have found negative results as they underestimated the financial costs and the logistical efforts involved to bring production back to the country of origin. Hence, countries like China, Malaysia, Vietnam, Indonesia, Mexico and Brazil remain popular locations for offshoring.

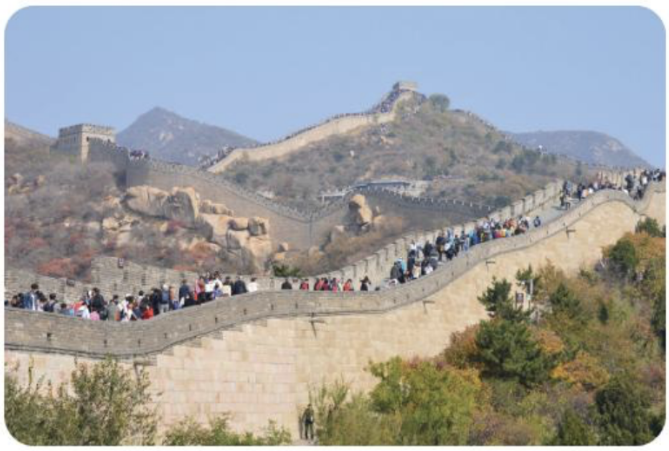

Figure 38.11 - Despite a trend in reshoring, China remains an attractive choice for offshoring

Question 38.8 - KFC, Vietnam

American fast food **multinational company** KFC opened its first store in Hanoi, Vietnam in 1997. KFC was the first high-profile fast-food chain to locate in the former communist country. Economic and political reforms have transformed the country with its relatively untapped retail potential. Vietnam has a large and youthful population and a fast-growing economy. Its entry into the World Trade Organization in 2007 has led to a significant rise in foreign direct investment (FDI).

Vietnam's economy is expanding due to growth in exports, domestic demand and the manufacturing sector. FDI has not slowed as the country has been earmarked to have annual economic growth rates of between 6.63% and 7.14% between 2022 and 2026. It is no surprise then, that KFC opened its 153rd store in 2021. In 2014, McDonald's followed KFC's move by opening its first restaurant in Hanoi, the country's capital city. However, with barely more than 20 restaurants in the country, McDonald's has been unable to dethrone KFC which remains the most popular fast-food chain in Vietnam.

(a) Define the term *multinational company*. *[2 marks]*

(b) Explain **one** benefit to KFC in being the first high-profile (well-known) fast-food chain to locate in Vietnam. *[2 marks]*

(c) Examine the factors that make Vietnam an attractive location for global giants such as KFC and McDonald's. *[6 marks]*

Location and the key concepts

The location decision is one of the most important and most difficult strategic choices for any sustainable business. Good location decisions require significant planning and quantitative analysis of the costs and benefits of alternative options. Two commonly used quantitative methods are investment appraisal (see Chapter 21) and break-even analysis (see Chapter 39). Investment appraisal methods are used to calculate the location with the quickest and/or highest financial return. Break-even analysis can help a business to identify which location is most likely to reach breakeven first after which the firm will start to earn profit. However, these quantitative methods must be used with some caution since the calculations are based on forecasts. Therefore, most managers will also use qualitative factors in their strategic assessment of the location decision.

Changes in the external environment (see Chapter 46) have meant that an increasing number of organizations have to consider both domestic and international location decisions, such as outsourcing, offshoring, insourcing and reshoring. This undoubtedly makes decision-making more challenging as there are external factors to consider (such as language and cultural issues or changes in the political stability of a country). International location decisions are further complicated by changes in exchange rates, which make financial comparisons rather more difficult.

Ethical factors have also meant that businesses have to increasingly consider qualitative factors when locating overseas. For example, McDonald's, KFC, Nike and Walmart have all been heavily criticised in the past for allegedly paying low wages to staff. Hence, international location decisions have increasingly been influenced by ethical considerations such as sensitivity towards differences in languages, cultures, etiquette and the political environment. Some of these factors present opportunities, such as:

- **Production costs** - The costs of labour, materials and transportation can be significantly lower in overseas markets. However, these benefits will need to be considered in relation to potentially higher distribution costs from the new location as well as the ethical treatment of workers in foreign markets.

- **Government rules and regulations** - Direct investment in overseas locations can help a business to get around government bureaucracy, such as import restrictions and duties (taxes). However, this may need to be weighed up against the costs of relocation, such as staff redundancies in the domestic country, which will need to be handled in an ethical manner.

- **Economies of scale** - Large multinational companies (MNCs) can gain huge cost savings by operating on a global scale, especially in countries with good infrastructure (such as transportation links and telecommunications networks). These economies of scale (see Chapter 5) can therefore help the business to be more competitive in a sustainable way.

However, the international location decision can also bring about its potential limitations, including:

- **Social responsibilities** - Ethical and moral issues may need to be considered. Coca-Cola, symbolic of American culture, controversially opened a bottling plant in Afghanistan during the 'war against terrorism' under the Presidency of George W. Bush.

- **Political environment and stability** - The political stability of a country will affect the profitability of firms, e.g., unethical and corrupt governments hinder business growth whereas financial incentives and tax concessions ease the burden associated with international location decisions.

- **Regulations and legalities** - As different countries have different laws, it can be costly to get proper legal advice about consumer protection, employment rights and health and safety laws.

- **Economic environment** - The economic prosperity of a country will also determine the profitability of businesses. Changes to key economic performance indicators, such as inflation, unemployment, interest rates and exchange rates (see Chapter 46) will all help a country to attract foreign direct investment.

- **Culture** - Societal norms about what is ethically acceptable and what is not will vary from country to country and region to region. A lack of cultural awareness or respect for ethical dimensions in overseas markets can get a business into all sorts of trouble (see Chapter 34).

- **Language** - Communications can be an issue if there are insufficient resources to deal with problems in overseas markets, e.g., the costs of hiring linguists and translators can be quite considerable for businesses located abroad.

Theory of Knowledge (TOK)

To what extent do language and culture influence international location decisions?

Changes in workforce planning (see Chapter 7) have meant a larger pool of flexible employees who work from their own home. This became more commonplace following national lockdowns during the COVID-19 pandemic. The changes have helped in the relocation decision of many businesses as they no longer need to rent such large premises in expensive locations. It may also be possible to relocate to less expensive areas if staff do not have an issue with access and transportation to the new site.

Changes in technologies have also made international location decisions somewhat easier for many businesses. For example, the widespread use of e-commerce means that banks can provide the convenience of e-banking facilities (such as electronic bill payments, bank transfers, stock exchange transactions, foreign currency exchange and travel insurance), which reduces the need for many customers to physically visit a bank. Such innovative changes have enabled more businesses to be **footloose organizations** meaning there are no cost advantages of any particular location. Jeff Bezos, founder of Amazon, started off by selling books from his own home. Dell computers are mainly ordered online without the need to visit a retail store, no matter how conveniently located it might be.



Figure 38.12 - E-commerce has enabled many more businesses to operate as footloose organizations

Common mistake

Some students seem to think that it does not matter where a footloose business locates. Whilst footloose businesses have a greater degree of choice of where they locate, the location decision is still important for business success. Even businesses that operate from home need to consider the logistics of delivering their products to customers as well as the suitability of their place of residence to conduct commercial activities.

Ultimately, the location decision is likely to affect all functional areas and aspects of business activity. The scope of these impacts depends on the type and size of the business, the products it sells and the infrastructure in the location itself. Considering these factors in the context of the business and its objectives allows better decisions to be made.

Business Management Toolkit

With reference to STEEPLE analysis (see Chapter 46), discuss how the external environment can influence location decisions.

Key concept

With reference to an organization of your choice, examine how **change** and **sustainability** have influenced its location decision.

REVIEW QUESTIONS

1. What is meant by the location decision?
2. Why might a location decision be said to be 'irreversible'?
3. What is meant by the relocation decision?
4. What are the main quantitative factors that affect the location decision?
5. How do bulk-increasing industries differ from bulk-reducing industries.
6. How might government incentives and limitations affect a firm's location decision?
7. How do qualitative factors affect the location decision?
8. How might e-commerce affect the location decision?
9. What is comparative shopping (clustering)?
10. How might local knowledge affect the location decision?
11. What is meant by outsourcing (subcontracting)?
12. What are the advantages and disadvantages of outsourcing?
13. How does outsourcing differ from offshoring?
14. What is meant by insourcing?
15. What is meant by reshoring?

KEY TERMS

Assisted areas (or **enterprise zones**) are regions identified by governments to experience relatively high unemployment and low incomes, so are in need of regeneration through financial assistance.

Bulk-increasing or **weight-gaining industries** are involved with products that increase in weight during the production process, so need to be located near their customers in order to reduce costs.

Bulk-reducing or **weight-losing industries** are those that need to locate near the source of raw materials because they are heavier and hence more costly, to transport than the final product.

Clustering means that a business locates near other organizations that operate in similar or complementary markets.

A **footloose organization** is a business that does not gain any cost-reducing advantages from locating in a particular location. Hence, the firm can locate in almost any location.

Government incentives are financial enticements offered by the state to businesses to locate in a particular area or region, perhaps due to high unemployment.

Industrial inertia describes the reluctance to relocate due to the inconvenience of moving even when the competitive advantages for the location no longer existed.

Infrastructure is the term used to describe the transportation, communication and support networks in a certain area.

Insourcing is the use of an organization's own people and resources to accomplish a certain function or task which would otherwise have been outsourced.

Location refers to the geographical position of a business, i.e., where it is sited.

Offshoring is an extension of outsourcing, which involves relocating business functions and processes overseas.

Outsourcing (or **subcontracting**) is the practice of transferring internal business activities to an external organization in order to reduce costs and increase productivity.

Reshoring is the reverse of offshoring, i.e., the transfer of business operations back to their country of origin.

Subcontractors are outsourced firms that undertake non-core activities for an organization. They are used for their expertise and the cost advantages they bring.

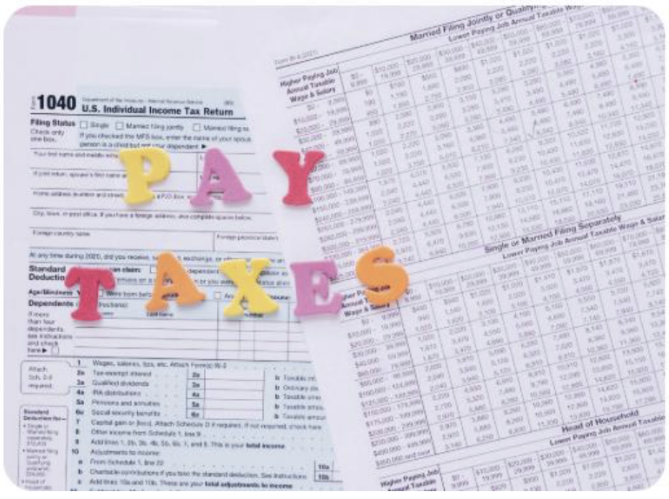

Figure 38.13 - Many businesses choose to use subcontractors for accountancy services

Chapter 39
Unit 5.5 - Break-even analysis

"Knowledge is of no value unless you put it into perspective"
- Anton P. Chekhov (1860 - 1904), Russian playwright

Contents

5.5 Break-even analysis	
SL/HL content	**Depth of teaching**
Total contribution versus contribution per unit	AO2
A break-even chart and the following aspects of break-even analysis: • break-even quantity/point • profit or loss • margin of safety • target profit output • target profit • target price	AO2, AO4
The effects of changes in price or cost on the break-even quantity, profit and margin of safety, using graphical and quantitative methods	AO2, AO4
Limitations of break-even as a decision-making tool	AO3

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Total contribution versus contribution per unit (AO2)

Contribution refers to the sum of money that remains after all direct or variable costs have been taken away from the sales revenue of a product. Hence, the surplus is the amount available to contribute towards paying the firm's fixed costs of production. Contribution can be categorized as total contribution or contribution per unit.

Contribution per unit (or **unit contribution**) is the difference between the selling price of a product and its variable costs of production. The surplus goes towards paying fixed costs.

The formula for calculating the contribution per unit is:

Contribution per unit = P – AVC

where P is the selling price and AVC is the average variable costs. Similarly, the **total contribution** is simply the unit contribution multiplied by the quantity of sales (Q) or the sales volume. Essentially, it is the gross profit earned on the sales of the product. Total contribution is calculated by using the formula:

Total contribution = (P – AVC) × Q

So, for example, if a firm sells wooden chairs at $100 each whilst the variable costs are $45 per chair, then the business earns a contribution of $55 per chair. Note that this is not the actual profit made because fixed costs have not yet been accounted for. However, each chair sold 'contributes' (adds) $55 towards the payment of the firm's total fixed costs (TFC). Once these have

been covered, further sales will contribute towards the profit of the business. **Profit** is the positive difference between a firm's total revenue and its total costs. On a break-even chart, profit is shown at all levels of output beyond the break-even quantity. It is calculated using the formula:

Profit = Total contribution – TFC

So, for example, if the wooden chair manufacturer has total fixed costs of $5,500 per time period, it would need to sell 100 chairs to cover all costs (fixed and variable). This is because:

- Total revenue = $100 × 100 chairs = $10,000
- Total variable costs = $45 × 100 chairs = $4,500
- Total fixed costs = $5,500
- Hence, total revenue – total costs = $10,000 – ($4,500 + $5,500) = 0.

Referring to the profit formula above, in theory, profit can be increased in the following ways:

- Increasing the sales volume of the product (the quantity sold), which raises the total contribution (or gross profit).
- Reducing variable costs, perhaps through negotiating better deals with current suppliers or seeking new suppliers that offer more competitive prices.
- Reducing fixed costs and overheads, perhaps through better financial control or the use of cost and profit centres (see Chapter 22).

Exam tip !

It is often quicker to calculate profit using total contribution than to use the alternative profit formula (total revenue minus total costs).

Business Management Toolkit

To consolidate your understanding of contribution, review Chapter 57 (contribution analysis), which is part of the Business Management Toolkit and Chapter 28 (contribution pricing for HL only students).

Break-even analysis (AO2, AO4)

A break-even chart and the following aspects of break-even analysis: break-even quantity/point, profit or loss, margin of safety, target profit output, target profit and target price. AO2, AO4

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Managers and owners of businesses are interested in knowing the difference between revenue and costs. A business can only survive in the long term if its revenues exceed its costs. This means it has to be profitable. In particular, break-even analysis is particularly relevant and important for new businesses as the owners will want to determine the level of sales that must be made in order to earn a profit. **Break-even analysis** is a quantitative tool that can be used for this purpose. A **break-even chart** is a diagrammatic representation of how total costs and total revenues change with increasing levels of production or sales. It shows a firm's costs, revenues and profits (or loss) at various levels of output.

Question 39.1 - Jade Villa Ltd.

Jade Villa Ltd. is a new business that offers holiday accommodation at a beach resort. It has fixed costs of $250,000 per year. The average variable cost of each letting is $250. The management at Jade Villa Ltd. plans to earn an average contribution of $1,000 per letting. It has forecast 300 lettings in the first year of operations.

(a) Calculate the average price that Jade Villa Ltd. should charge. *[2 marks]*

(b) Calculate the forecast profit or loss for Jade Villa Ltd. during its first year. *[2 marks]*

A business can be in one of the following financial situations at any point in time:

- **Loss** - when the firm's total costs exceed its total revenues (TC > TR).
- **Break-even** - when the total revenues of the business equal its total costs (TR = TC).
- **Profit** - when the firm's total revenues exceed its total costs (TR > TC).

Carrying out a break-even analysis can inform managers of two important things:

- Whether it is financially worthwhile to produce or launch a particular good or service
- The expected level of profits that the business will earn if things go according to plan.

Consider the following numerical example. A jeans retailer has fixed costs of $3,500 per month. Variable costs are $10 per pair of jeans and the selling price is $30. There are three ways that can be used to determine the **break-even point** (see Box 39.1 for a list of break-even formulae):

1. Using the TR = TC rule

   The **break-even quantity** (BEQ) is the level of output where total costs (TC) are equal to total revenues (TR). It is shown along the *x-axis* on a break-even chart. Recall from Chapter 15 that total revenue is calculated as Price × Quantity sold and that total costs consist of both fixed and variable costs. The BEQ can then be calculated as:
   - TR = TC
   - P × Q = TFC + TVC
   - 30Q = 3,500 + 10Q
   - 20Q = 3,500
   - Hence, the BEQ = 175 pairs of jeans

2. Using the contribution per unit rule

   This is the quicker of the two quantitative methods of calculating break-even. The formula is BEQ = Fixed Costs ÷ Contribution per unit. So, applying the above figures, we get:
   - Contribution per unit = Price *minus* Average variable costs = $30 – $10 = $20
   - Therefore, the BEQ = $3,500 ÷ $20 = 175 pairs of jeans.

3. Interpretation from a break-even chart.

   In Figure 39.1, the break-even level of output can be seen on the x-axis at the point where TC = TR, i.e., 175 pairs of jeans.

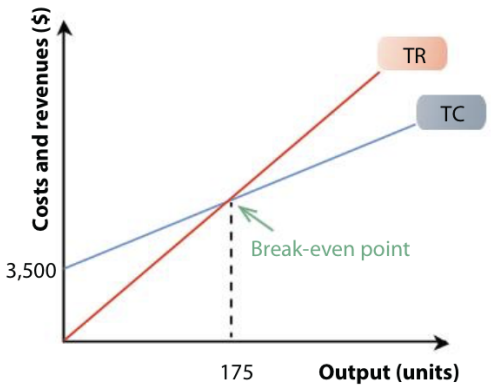

Figure 39.1 - Break-even chart

Note that the break-even point (BEP) refers to the position on a break-even chart where the total cost line intersects the total revenue line, i.e. where TC = TR. At this level of output, the firm does not make any profit but does not incur a loss either.

Box 39.1 - Break-even formulae

- Unit contribution: P – AVC
- Break Even: TC = TR
  Or
  $\frac{\text{Total fixed costs}}{\text{Unit contribution}} = \frac{\text{TFC}}{\text{P – AVC}}$
- Profit (or loss): TR – TC
  Or
  Total contribution – Total fixed costs
  = [(P – AVC) × Q] – TFC

All three methods give the same answer - the business needs to sell 175 pairs of jeans each month to reach break-even. The chart also shows that any sales beyond the break-even level of output generates a **profit** for the firm, whereas selling less than the BEQ means it makes a **loss** for that month (see Figure 39.2).

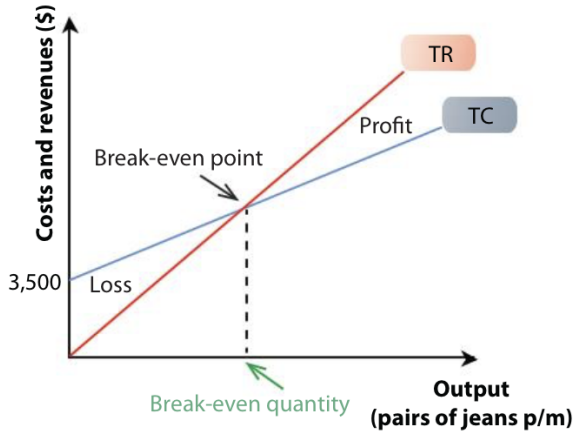

Figure 39.2 - Profit and loss on a break-even chart

Break-even analysis is particularly useful to businesses that:

- Produce and/or sell a single, standardized product.
- Operate in a single market.
- Make products to order, so that all output is sold.

Common mistake

Candidates often label the axes on a break-even graph inaccurately. In particular, the y-axis is often labelled as 'Costs' although break-even analysis clearly considers revenues too. The unit of measurement ($) is also often missing. Hence, the correct label should be 'Costs and revenues ($)'.

Exam tip !

Break-even analysis is a popular examination topic. Therefore, it is important that you are able to accurately construct and interpret information shown in a break-even chart. Also of importance is that you must be able to modify a break-even chart and analyze its implications for a business.

Common mistake

Many students seem to think that calculating the break-even point will actually ensure the firm covers its costs and makes profit. Of course, calculating the BEQ does not mean the firm has actually sold anything(!)

Question 39.2 - Graham Go-Karts!



Steve Graham is the owner of Graham Go-Karts! The firm has fixed costs of $20,000 per month. He charges $35 per ride, which allows customers to go round the track for 20 minutes. The cost of operating each ride, including the fuel costs, averages $10. In an average month, Graham Go-Karts! has 855 riders.

(a) Calculate the break-even quantity (number of riders) for Graham Go-Karts! *[2 marks]*

(b) Calculate the value of total revenue at the break-even quantity. *[2 marks]*

(c) Calculate the value of total costs at the break-even quantity. *[2 marks]*

(d) Calculate the level of profit for Graham Go-Karts! in a typical month. *[2 marks]*

The **margin of safety** (MOS) measures the difference between a firm's sales volume and the quantity needed to break-even. It shows the extent to which the demand for the firm's product exceeds the BEQ. A positive MOS means that the firm makes a profit (as actual sales are greater than the BEQ), whereas a negative safety margin means the firm makes a loss. The greater the positive MOS, the safer the firm will be in terms of earning profits, especially if there are adverse changes in the marketplace. It is calculated using the formula:

Margin of safety =
Actual sales quantity *minus* Break-even quantity

For example, if the demand for the jeans retailer in the above example is 280 pairs per month, then the safety margin is 105 units (i.e. 280 minus 175). This means that the business can sell 105 pairs of jeans less than its current level without making a loss (see Figure 39.3). Hence, the smaller the MOS, the more vulnerable a business becomes to changes in the market.

Some businesses prefer to express the margin of safety as a percentage of the BEQ because this puts the MOS figure into context and allows better comparisons to be made. In this case, (105 ÷ 175) × 100 means that the MOS is 60% higher than the break-even level of output. Hence, the MOS can reveal the degree of risk involved in a business decision.

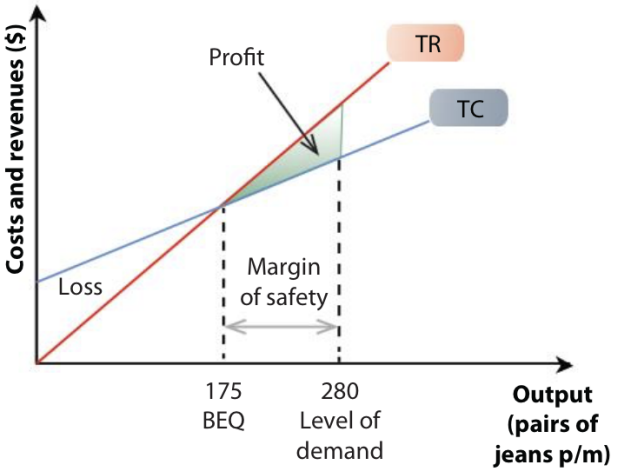

Figure 39.3 - The margin of safety

Common mistake

Far too often, candidates express the margin of safety as a monetary value. This clearly shows a lack of understanding and application of the concept. The MOS is calculated and shown on the *x-axis* of a break-even chart, which means the unit of measurement is the volume of output rather than the *value* of that output.

Question 39.3 - Calculating the margin of safety

Tread-it Inc. is a manufacturer of hiking shoes. Play-it Co. produces wooden toys for children. Cost and revenue data for both businesses are shown in the table below

	Tread-it	Play-it
Break-even quantity	250	500
Output	500	*(i)*
Margin of safety (units)	*(ii)*	300
Margin of safety (%)	100	*(iii)*

(a) Calculate the missing figures for *(i)*, *(ii)* and *(iii)* in the table above. *[3 marks]*

(b) Comment on which firm has the better margin of safety. *[4 marks]*

To construct an accurate break-even chart (such as shown in Figure 39.5), use the following rules:

1. Although not necessarily required to show break-even, it is conventional to draw and label the horizontal total fixed costs (TFC) line

2. The total costs (TC) line is drawn and labelled. Recall that even when there is no output, fixed costs still have to be paid. Hence, the TC line starts at the same level as TFC.

3. The total revenue (TR) line is drawn and labelled. When there is no output or sales, the total revenue is zero. Hence, the TR line starts at the origin.

4. The *x-axis* is labelled as 'Output' and measured in the appropriate unit of measurement, per time period.

5. The *y-axis* is labelled as 'Costs and revenues', expressed in terms of a currency.

6. A title, written in the context of the business, should also be added.



Figure 39.4 - Bespoke jewellery.

© Photo courtesy of Katia Torralba Jewellery Ltd.

Exam tip !

Before drawing a break-even chart, it is important to first work out the value of the costs and revenues at the break-even quantity. This will help you to determine the scale needed to plot the figures on the *y-axis*. By working out the BEQ beforehand, it is also easier to determine the scale needed for the *x-axis*.

Consider the following worked example as a point of illustration. Suppose that Katia Torralba Jewellery Ltd. sells hand-made necklaces at an average price of $260 with variable costs averaging $120 per unit. The fixed costs are $3,500. To plot the break-even chart, it is necessary to first calculate:

- The BEQ - Using the contribution per unit method, the BEQ is worked out as 3,500 ÷ (260 – 120) = **25 units**.

- The value of costs and revenue at the BEQ - Since the value of TC and TR are the same at the BEQ, it does not matter which component is worked out. For example, TC = $3,500 + ($120 × 25) = $**6,500**. Equally, if we calculate the TR, the figure would be $260 × 25 = $**6,500**.

Using this information, it is now possible to plot the break-even chart. We know that the *x-axis* must go to beyond 25 units (the BEQ) and that the *y-axis* must go beyond $6,500 (the value of the costs and revenue at the BEQ).

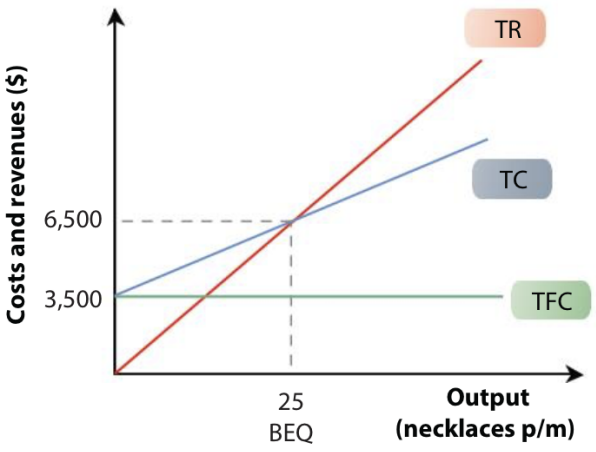

Figure 39.5 - Break-even chart for Katia Torralba Jewellery Ltd.

Question 39.4 - TMR Day-Care Centre

Thuy and Mark Rees run a children's day-care centre in Hanoi, Vietnam. The main clients are working parents, who pay a fixed $20 per child for the day. Children learn through play and are engaged in activities such as art, music, dance and physical education at TMR Day-Care Centre. The business is open for an average of 22 days each month. The firm's expected costs and revenue for the next year are as follows:

Capacity	25 children per day
Demand	80% of capacity
Price	$20 per child per day
Materials	$4 per child
Rent	$600 per month
Salaries	$1,000 per month
Administration	$100 per month
Utility bills	$140 per month



(a) Calculate the sum of the fixed costs for TMR Day-Care Centre. *[2 marks]*

(b) Calculate the break even quantity per month. *[2 marks]*

(c) If TMR Day-Care Centre works at 80% of its capacity, calculate the margin of safety. *[2 marks]*

(d) Construct a fully labelled break even chart for TMR Day-Care Centre. *[5 marks]*

(e) Identify the break even point, the break even quantity **and** the margin of safety on your break even chart. *[3 marks]*

(f) Examine the strengths and weaknesses of using break-even analysis for a business such as TMR Day-Care Centre. *[6 marks]*

Exam tip !

If the break-even quantity is a decimal number, such as 185.33, then the value has to be rounded *up* (to 186 in this case) because businesses cannot sell a third of a product to a customer!

Continuing from the earlier example of Katia Torralba Jewellery Ltd., it is possible to use a break-even chart to work out the level of sales needed to earn a certain amount of profit. This is known as the **target profit.** Target profit is the amount of surplus a firm intends to achieve, based on price and cost data. It is calculated by deducting total costs from expected sales revenues. For example, for the firm to earn a target profit of $5,600 per month, it can be seen from Figure 39.6 that the firm needs to sell 65 necklaces.

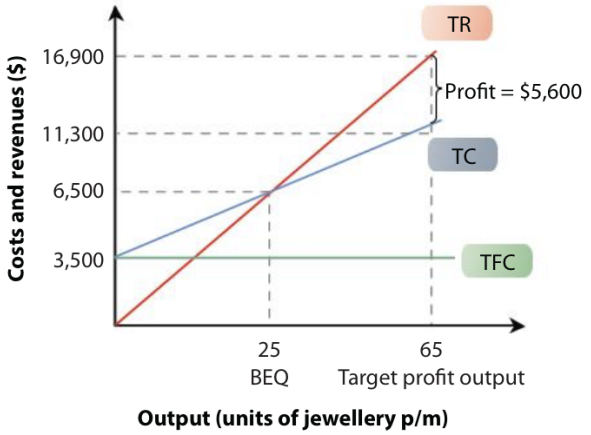

Figure 39.6 - Break-even chart for Katia Torralba Jewellery Ltd

The **target profit output** is the sales volume or level of output required to achieve the target profit that business managers expect to achieve by the end of a given time period. To calculate the target profit output level of a firm, use the following formula:

$$\textbf{Target profit output} = \frac{\textbf{(Fixed costs + Target profit)}}{\textbf{Contribution per unit}}$$

Target profit output can also be worked out manually, without the use of a break-even chart by using the following steps:

- Target profit = TR *minus* TC
- 5,600 = 260Q – 3,500 – 120Q (with $260 being the target price)*
- 9,100 = 140Q
- Hence, Q = **65 units** (the target profit output)

* **Target price** is the price set by a business in order to reach break-even or (more often the case) a desired target profit.

- The target revenue can then be worked out as TR = $260 × 65 = $16,900
- The total costs at 65 units of output = $3,500 + ($120 × 65) = $11,300
- Therefore, the target profit is $16,900 – $11,300 = **$5,600**

Whilst profit can be seen from a break-even chart, it is typically calculated by working out the difference between total revenues (TR) and total costs (TC). For example, suppose that Katia Torralba Jewellery Ltd. sells 50 necklaces per month. Profit can be worked out using the TR – TC rule:

- TR = $260 × 50 = $13,000
- TC = $3,500 + ($120 × 50) = $9,500
- Profit = $13,000 – $9,500 = **$3,500**

Alternatively, the total contribution method can be used to work out profits at this level of output. Recall that **Profit = Total contribution – TFC**.

- Total contribution = ($260 – $120) × 50 = $7,000
- TFC = $3,500
- Hence, profit = $7,000 – $3,500 = **$3,500**



Figure 39.7 - Profit is what remains after all costs have been paid

Question 39.5 - Creighton Tours

Edward Creighton is a tour operator for holidaymakers in Thailand. His business specialises in arranging English-speaking tours to remote areas of Thailand. Creighton Tours has monthly **fixed costs** of $3,500. The cost of operating each tour averages $120. Edward's monthly sales target is 60 clients and the firm has a **target profit** of $2,500.

(a) Define the term *fixed costs*. *[2 marks]*

(b) Define the term *target profit*. *[2 marks]*

(c) Calculate the target price of the average tour for Creighton Tours. *[2 marks]*

(d) Calculate the contribution from each tour. *[2 marks]*

(e) Calculate the break-even quantity for Creighton Tours. *[2 marks]*

Question 39.6 - Mendoza Taxi Services

José Mendoza runs a taxi service in Manila, Philippines. The average fare paid by customers is 330 pesos. Mendoza Taxi Services has fixed costs of 6,400 pesos and the average cost of each journey is 130 pesos. The average number of taxi journeys is 66 each month.

(a) Calculate the break-even quantity for Mendoza Taxi Services. *[2 marks]*

(b) Calculate the margin of safety for Mendoza Taxi Services. *[2 marks]*

(c) Calculate the current annual profit for Mendoza Taxi Services. *[2 marks]*

(d) Calculate the target price of each journey if Mendoza Taxi Services has a monthly target profit of 8,000 pesos *[2 marks]*

Exam tip !

Make sure you read the questions about break-even very carefully and pay attention to the various units of measurement. For example:

- The break-even quantity should be expressed in terms of units of output.
- The margin of safety should also be expressed in terms of units of output.
- Costs, revenues, profits and losses should be expressed in terms of a currency (usually $).
- Target profit and target price should be expressed in terms of a currency (also usually $).

Changes in break-even (AO2, AO4)

The effects of changes in price or cost on the break-even quantity, profit and margin of safety, using graphical and quantitative methods. AO2, AO4

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Break-even analysis is a useful management planning and decision-making tool for asking 'what if' questions. The model provides a quick graphical illustration of the cost and revenue structures of different scenarios and projects. For example, it allows managers to quickly visualise the impact of changes in price and/or costs on the break-even quantity, profit and margin of safety for the business (see Question 39.7).

Break-even analysis can also be used to make realistic predictions based on changes in price or cost, rather than relying on simple guesswork. For example, a restaurateur can use past data and experience to estimate the average cost of a meal, the average number of customers on different days of the week and the average price paid for each meal. This data can therefore help a multi-product firm to work out its break-even level of sales, albeit somewhat inaccurately perhaps.

Question 39.7 - RT's Hotdogs

Rhys Thomas runs a small hot dog stall outside a busy shopping mall. The forecasts for his sales revenues and costs for the next few months are shown below:

Capacity	200 hotdogs per day
Sales volume	110 hotdogs per day
Unit price	$2.50
Ingredients and materials	$0.8 per hotdog
Rent	$200 per month
Salary	$500 per month
Other overhead costs	$320 per month

(a) Construct a break-even chart for RT's Hotdogs, showing the monthly break-even quantity. *[5 marks]*

(b) Assume that the average daily sales volume increases to 70% of capacity and that rent rises by 50%. Determine the effect of these changes on your break-even chart and comment on your findings. *[5 marks]*

CORE

Nevertheless, actual break-even, profits or losses and margins of safety are likely to be different from those predicted in a break-even analysis because there are so many factors that can affect the operations of a business. These factors include:

- The difference between short term and long-term profits - It might be necessary to reduce prices (subsequently increasing the break-even quantity) in order to attract customers, especially if demand is price elastic (see Chapter 28). In the long term, prices can be increased once a loyal customer base and brand loyalty (see Chapter 27) have been established.

- The level of demand is subject to change - Factors that affect demand, such as changes in income or fashion, will alter the BEQ and hence the margin of safety and value of profits or losses.

- Profit depends on the level of risks involved - Whilst low-risk projects generally lead to a quicker BEQ, the value of the profits is likely to be low. High-risk projects, such as the Airbus A380 (see Question 39.9), have the potential of huge amounts of profits but have a high BEQ. Of course, as a forecasting tool, the forecasted profits might not materialise in reality.

- Innovation and the introduction of new technologies - Dell computers, Dyson vacuum cleaners and Apple iPads have generated sales and profits far in excess of their original forecasts.

- Non-price determinants of demand - Demand for goods and services are not solely determined by price. Other factors that affect demand and hence profits and safety margins, include quality, branding, seasonality, changing fashions and tastes and income.

- Luck! Every business needs a little bit of luck to succeed. External factors such as changes in exchange rates, unemployment, national income and interest rates (see Chapter 46) can have a direct impact (positive or negative) on the profitability of businesses.

Question 39.8 - Ana Hermosa Art Studios

Ana Hermosa owns an art studio business in Madrid, Spain. Ana Hermosa Art Studios has overhead costs of €3,000 per month. The variable costs and price are €5 and €20 respectively, per person per lesson. There are typically 500 customers each month, although the studio can accommodate a maximum capacity of 600 clients.

(a) Calculate the break-even quantity for Ana Hermosa Art Studios. *[2 marks]*

(b) Calculate the margin of safety for Ana Hermosa Art Studios. *[2 marks]*

(c) Construct a fully labelled break-even chart for Ana Hermosa Art Studios. *[5 marks]*

Suppose in the subsequent time period that rent rises, thus raising the firm's **overheads** to €4,000 per month. Ana Hermosa also reduces the price to $17, which raises demand to 520 clients per month.

(d) Define the term *overheads*. *[2 marks]*

(e) Calculate the new break-even quantity for Ana Hermosa Art Studios and comment on your findings. *[4 marks]*

(f) Illustrate the new break-even level of output on your original chart. *[1 mark]*

(g) Explain whether the change in price was a sensible decision by Ana Hermosa. *[4 marks]*

Limitations of break-even (AO3)

The limitations of break-even as a decision-making tool. AO3

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Despite the potential usefulness of break-even analysis as a decision-making tool, there are limitations. A key limitation is the assumptions made in a break-even analysis, as these are rarely ever met by most businesses in reality:

- It assumes that all cost functions are linear. In reality, cost curves are highly unlikely to be linear because economies of scale (see Chapter 5) and hence lower average costs of production, can be gained by operating on a larger scale. Fixed costs might also change, perhaps due to an increase in rent, for example.
- It also assumes the sales revenue (total revenue) function is linear. In reality, customers may demand discounts for larger orders, thereby distorting the gradient of the sales revenue line on a break-even chart. To sell more, a business might also need to reduce its prices, again changing the slope of the revenue line. Also, a linear sales revenue function ignores pricing methods such as dynamic pricing (see Chapter 28) used by many businesses (charging different prices for goods and services due to changing market conditions, such as peak- and off-peak times).
- It assumes that the business will sell all of its output. However, in reality most businesses will have some unsold stocks (inventories), which do not generate cash but cost the firm money (storage and insurance costs, for example). Furthermore, unsold stock might need to be sold at a discounted price (thereby reducing the profits) to make space for new incoming stocks.

Beyond the assumptions of the model, there are additional limitations. These include:

- Break-even analysis is a static decision-making model. This means it might not be very useful in a dynamic business environment. For example, it ignores the possibility that production costs can and do change at short notice, such as fluctuating exchange rates which affect the costs and revenues of multinational companies. The use of dedicated computer software, such as spreadsheets, can help to update data more easily, but each set of break-even calculations will only be valid for one point in time.
- As with all financial and numerical predictions, the principle of garbage in, garbage out (GIGO) applies. This

means that unrealistic and obsolete data input will generate unconvincing and unreliable results. Hence, the accuracy of break-even analysis largely depends on the validity of the original data (used to generate the calculations) and on management skills and experiences (to accurately estimate costs and revenues).

- Other quantitative and qualitative factors that can alter the costs, revenues and output of the business are ignored. For example, the model ignores the impacts of staff working under increased pressures to maximize output, such as demotivation and declining productivity. The reaction of competitors, the availability of spare capacity and access to sources of finance to fund expansion of output are also ignored in a break-even analysis.
- The model is really only suitable for single-product firms that sell all of their output. For firms with a broad product portfolio, overheads have to be split between the various products in a rather subjective way (see Chapter 57). Although there are software programmes that can help managers to calculate multiproduct break-even, these do not truly represent the break-even for each individual product.



Figure 39.8 - Break-even analysis is not so useful for vendors that sell multiple goods

CORE

Question 39.9 - Airbus A380



Prior to its first commercial flight in 2007, the Airbus A380 - the world's largest passenger airliner - was estimated to break-even on 270 orders with an average price of $375.3 million. However, the company later announced the break-even quantity had been revised to 420 aircraft following production delays and soaring costs that had plagued the European aircraft giant. At that time, Airbus had only sold 159 A380s, with the first plane delivered to Singapore Airlines two years behind schedule. By 2013, the average list price of the A380 was $390m with a total of only 251 orders by 2021. The largest customer of the A380 is Emirates, with a total of 123 planes. Airbus had expected to sell 1,200 A380 planes during its first 20 years. However, with its last order placed in 2019, by Emirates, Airbus ended production of the A380 in 2021. The $25 billion investment in the A380 was never recouped.

(a) Define the term *break-even quantity.* *[2 marks]*

(b) Calculate the revised margin of safety for the Airbus A380. *[2 marks]*

(c) Comment on how the change in the margin of safety is likely to affect Airbus. *[4 marks]*

(d) Examine how the delays and soaring production costs might affect the profits of Airbus. *[6 marks]*

(e) Examine the value of break-even analysis as a management tool for businesses such as Airbus. *[6 marks]*

Common mistake

Students often think that a benefit of calculating the break-even point ensures that the business will cover its costs and hence make a profit. This is not the case, as BEA is a tool used to support decision-making; it does not guarantee a profit will be made and it is possible for the safety margin to be negative.

Theory of Knowledge (TOK)

Does it matter if the assumptions of break-even analysis are actually flawed? Do assumptions diminish our knowledge in any way?

Exam tip !

Break-even analysis has been a particularly popular topic for SL students. Whilst it is important to practise how to construct break even charts, it is equally important to be able to examine the benefits and limitations of break-even analysis as a decision-making tool.

Break-even analysis and the key concepts

The concept of contribution is crucial to the understanding of break-even analysis as well as other aspects of the Business Management course (see Chapter 57). Recall that *unit contribution* is the difference between a product's price and its variable costs of production, i.e., unit contribution = P – AVC. Any product that makes a positive contribution will help towards paying some of the fixed costs of the business and therefore support the sustainability of the organization.

Despite its limitations, BEA is a useful quantitative planning and decision-making tool for presenting cost and revenue data to aid strategic decisions in order to cope with changes in the internal and external business environments, such as:

- *Product portfolio management* (see Chapter 27) - Break-even analysis helps to assess the expected BEQ prior to the launch of a new product, thereby helping firms to manage their changing product portfolios. Although the analysis works best for single-product firms, allocating overheads (see Chapter 57) can help to alleviate this issue.

- *Risk assessment* - Calculating the margin of safety helps managers to gauge the level of risk involved in a particular project. A predicted safety margin of 250% might justify the go-ahead for a project, despite possible changes in the internal and external environments. By contrast, a negative safety margin can prevent a loss being made had the firm intuitively invested in the project, thereby helping to sustain business operations of the organization.

- *Make-or-buy decisions* (see Chapter 57) - As the name suggests, these decisions refer to a firm's choice of whether to produce a product itself or to buy it from a supplier. Such decisions consider the cost to make (CTM) and the cost to buy (CTB), as explained in Chapter 40. Hence, make-or-buy decisions provide some flexibility and creativity in decision making as businesses can consider the relative benefits of either decision. The break-even analysis enables the firm to consider the CTM, whereas outsourced suppliers provide greater options and creative solutions if the CTB is attractive.

- *Special order decisions* - These are atypical and/or one-off orders for which a business will charge a price that differs from the norm. For example, some customers might demand speedier delivery times, changes to the product specification or creative service-based solutions, thereby raising production costs. The use of break-even analysis can help to assess whether the change in profits - by accepting the special order - is a worthwhile decision (see Box 39.2). Hence, break-even analysis can be used in a creative way to cater for changes in the business environment.

Box 39.2 - Special order decisions: a numerical example

Suppose a charity wishes to buy 10 computers at a price of $500 each instead of the usual $800 price tag from a manufacturer. Unit variable costs of the computers are $200 and fixed costs are allocated at $3,000. Assuming the manufacturer has spare capacity, recommend whether it takes on this special order.

Break-even analysis shows that the BEQ is 10 computers, i.e., $3,000 ÷ ($500 – $200).

There are three possible outcomes:

- Based on financial grounds, the manufacturer only breaks even. For some firms, this will not be worthwhile, especially if production costs turn out to be higher than expected.
- Based on qualitative factors such as corporate social responsibility (see Chapter 3), the firm might take on the order as it feels that the charity is supporting a worthwhile cause.
- Based on *contribution analysis*, the fixed costs exist with or without this special order. So, by taking it on, there is a contribution of $300 per computer. Hence, some firms would accept the special order.

Theory of Knowledge (TOK)

Is there any justification for profit maximizing companies to accept a special order solely because of ethical reasons?

Theory of Knowledge (TOK)

How do theoretical models, such as break-even analysis, support or hinder our search for knowledge?

Key concept

Discuss the extent to which **change** and **creativity** limit the usefulness of break-even analysis as a decision-making tool.

Business Management Toolkit

Discuss the inclusion of break-even analysis in a business plan. You might want to refer to Chapter 48 before attempting this task.

Business Management Toolkit

Discuss how changes in the external environment (STEEPLE analysis) might impact on break-even for a business. You might want to refer to Chapter 46 before attempting this task.

As with all quantitative tools, it is important to consider the outcomes of a break-even analysis in the context of the business, such as its business objectives (see Chapter 3) and organizational culture (see Chapter 11). It is also essential to remember that break-even analysis should be used with some caution, bearing in mind the assumptions of the model. Furthermore, break-even analysis could be used alongside other tools such as SWOT analysis (see Chapter 44) and investment appraisal (see Chapter 21) to form more comprehensive and coherent strategic decision-making.

REVIEW QUESTIONS

1. What is contribution and why is it important for understanding break-even analysis?
2. What is contribution per unit (or unit contribution)?
3. How is contribution per unit used to calculate break-even output?
4. What is the meaning of total contribution?
5. What is the difference between profit and loss?
6. How is profit calculated by using the contribution method?
7. What is break-even analysis?
8. What does a break-even chart show?
9. How does the break-even point differ from the break-even quantity?
10. What is meant by the margin of safety (or safety margin) and how is it calculated?
11. What is target profit?
12. What is target profit output?
13. What is target price?
14. What are the assumptions made when carrying out a break-even analysis?
15. What are the limitations of break-even analysis?

KEY TERMS

Break-even analysis is a decision-making tool used to calculate the level of sales needed to cover all costs of production. Any sales beyond the break-even point generate a positive safety margin and hence profit for the business.

Break-even chart is a diagrammatic representation of a firm's costs, revenues and profits (or loss) at various levels of output.

Break-even point refers to the position on a break-even chart where the total cost line intersects the total revenue line. This is shown at the point where TC = TR.

Break-even quantity refers to the level of output that generates neither profit nor loss. It is shown along the *x-axis* on a break-even chart.

Contribution refers to the sum of money that remains after all direct or variable costs have been deducted from the sales revenue of a product.

Contribution per unit (or **unit contribution**) is the difference between the selling price of a product and its variable costs of production, i.e., P - AVC.

A **loss** exists when the firm's total costs exceed its total revenues (TC > TR). This occurs at all levels of output or sales below the break-even quantity.



Figure 39.9 - Losses can cause businesses to go bankrupt

The **margin of safety** is the difference between a firm's actual sales quantity and its break-even quantity. A positive safety margin means the firm can reduce output (or sales volume) by that amount without making a loss.

Profit is the positive difference between a firm's total revenue and its total costs. Profit is shown in a break-even chart at all levels of output beyond the break-even quantity.

Target price is the price set by a firm in order to reach break-even or a certain target profit.

Target profit is the amount of surplus a firm intends to achieve, based on price and cost data. It is calculated by deducting total costs from expected sales revenues.

Target profit output is the sales volume or level of output required to achieve the target profit that business managers expect to achieve by the end of a given time period.

Total contribution is the unit contribution (P – AVC) multiplied by the quantity of sales (Q). Hence, total contribution = (P – AVC) × Q.

Chapter 40
Unit 5.6 - Production planning (HL only)

"It's a bad plan that cannot be changed."
- Italian Proverb

Contents

5.6 Production planning (HL only)	
HL content	**Depth of teaching**
The local and global supply chain process	AO2
The difference between JIT and just-in-case (JIC)	AO3
Stock control charts based on the following: • lead time • buffer stock • re-order level • re-order quantity	AO2, AO4
Capacity utilization rate	AO2, AO4
Defect rate	AO2, AO4
Labour productivity rate, capital productivity, operating leverage	AO2, AO4
Cost to buy (CTB) Cost to make (CTM)	AO2, AO4 AO2, AO4

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The supply chain process

The local and global supply chain process. AO2
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Production planning refers to the management process of ensuring sufficient resources (such as raw materials, components and labour) are available for use to create finished products (goods or services) in a timely manner to meet the needs of customers. The supply chain process is an essential aspect of production planning. The **supply chain** refers to the different stages of activities from the production of a good or service to it being distributed to the end customer. **Supply chain management** (SCM) is the art of managing and controlling these activities, which must be efficient and cost effective for a business to be profitable. For example, freight and transportation costs will clearly add to the overall expenses of the business, especially for firms that operate on a global scale. Nevertheless, operations in overseas countries can help to lower production costs so make it attractive for some businesses to expand a supply chain to other parts of the world. **Global supply chains** refer to the networks that span multiple countries and regions for the purpose of sourcing and supplying goods and services. The supply chain process and SCM, be it local or global, will usually involve several key functions:

- *Stock control* - Managers must plan, implement and monitor the movement and storage of all stocks (categorized as raw materials, work-in-progress or finished goods).
- *Quality control* - All stages in the supply chain process must be managed effectively to add value in order to attract

customers to buy quality products, thereby generating profit for all firms in the supply chain.

- *Supplier networks* - The decision will need to be made regarding which suppliers or intermediaries to use. Collaboration between the partners in the supply chain can facilitate improvements in the supply chain process, thereby helping to reduce costs without compromising quality.

- *Transportation networks* - The most cost-effective methods of distributing products to customers must be investigated. This will depend on factors such as the frequency, speed, reliability and the costs of different transportation systems. Large businesses such as supermarket chains are able to provide their own distribution networks, whereas smaller organizations may need to use sub-contractors and couriers.



Figure 40.1 - Transportation networks are fundamental to global supply chain management

Reasons for using supply chain management include:

- Long supply chains increase the chances of things going wrong. Hence, effective SCM can prevent mistakes that would otherwise adversely affect the business and its profits.

- SCM helps to ensure that an appropriate supply of stocks is used to meet the level of customer demand. Too much supply causes stockpiling, with its associated costs, whilst a lack of stock causes delays to the rest of the supply chain. SCM helps to identify and prevent such bottlenecks.

- Global supply chains can make it easier for businesses to sell to customers around the world. A multinational company that has operational bases in other parts of the globe will tend to find it easier to sell products to customers in those parts of the world.

- Having a broad or global supply chain enables businesses to spread risks. For example, if a particular area has a severe natural disaster, businesses with operations in other parts of the world can continue without the tragedy causing a halt to their operations.

- SCM is a tool for achieving *lean production* (a system based on minimal input for maximum output, as explained in Chapter 37) by helping an organization to identify areas of wastage and inefficiencies.

All suppliers in the supply chain are interdependent. For example, the retailer is dependent on the manufacturer, who in turn depends on suppliers of components and raw materials. However, suppliers of raw materials rely on retailers who sell the final product to consumers in the tertiary sector. For example, there is little need to harvest cocoa if there is low consumer demand for chocolates. Hence, it is in the best interest of all firms in the supply chain to work collaboratively for their mutual benefits.

However, SCM has its potential problems:

- With increased globalization and more international trade, the SCM process becomes more complex. There are more partners in the supply chain to deal with, perhaps from various parts of the world, dealing in different languages and time zones. Time lags and potential cultural conflicts can delay getting the right products to the right customers at the right time in a cost-effective way.

- Greater interdependence also means that a single problem in the supply chain can cause major disruptions. Having global operations will increase the chances of something going wrong somewhere along the supply chain.

- Similarly, the greater need for partners to share information and to collaborate in the supply chain process also involves building trust among the partners. This requires sufficient time and resources.

- The process may require more time and resources devoted to managing supply chains. For example, this may involve quality control to minimise waste and systems to prevent employee theft in order to avoid financial losses. This is particularly important for businesses that have valuable inventories being made or stored in warehouses.

Question 40.1 - Carrefour

Carrefour is a French hypermarket chain that operates on a global scale. It is one of the largest retailers in the world, with annual sales revenue in excess of €80 billion ($92bn). The vast number of products sold in its 12,225 retail stores across 30 countries across numerous continents means that the company must have an effective **supply chain process**. Carrefour's business strategy is simple: it places emphasis on **price**, complemented by its constant pursuit of improvement in services for customers.

Source: adapted from https://www.carrefour.com/en

(a) Define the term *supply chain process.* *[2 marks]*

(b) Define the term *price.* *[2 marks]*

(c) Examine how Carrefour can improve the efficiency of its global supply chain process. *[6 marks]*

Just in time (JIT) and Just in case (JIC)

The difference between JIT and just-in-case (JIC). AO2

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One of the key aims of production planning is to minimize the costs of holding stocks whilst ensuring that there are sufficient resources for production to be able to meet customer demand in a timely manner. This is complicated by seasonal fluctuations in demand, such as the high demand for fresh flowers during Valentine's Day and Mother's Day whilst there may be little demand for flowers at other times of the year. Stock control examines the need for businesses to identify their optimum stock levels in order to remain competitive. This requires careful production planning and flexible processes, such as spare capacity to operate during peak trading periods and multi-skilled staff who are able to perform different jobs at short notice. Just-in-time (JIT) and just-in-case (JIC) are two types of stock control methods.

Just-in-time (JIT)

Just-in-time (JIT) is a stock control system based on stocks being delivered as and when they are needed in the production process. This means that a **buffer stock** (the predetermined minimum level of stock, also referred to as the reserve stock) is not required. Finished goods are dispatched as soon as they have been produced, thereby eliminating the need for storage. JIT, a Japanese philosophy first advocated by former Toyota executive Taiichi Ohno, is seen as a prerequisite to lean production (see Chapter 37) because purchasing and holding onto inventory can be costly and inefficient. JIT systems rely on automation, bar codes and the use of highly skilled and motivated workers. The advantages and disadvantages of JIT are outlined in Table 40.1. JIT is covered in greater detail in Chapter 37.



Figure 40.2 - JIT relies on reputable suppliers to deliver stocks on time

Case study 40.1 - The BMW Mini

The BMW Mini is assembled using a JIT system. Customers place specific orders before the cars are made. Each component is ordered to be available when needed for production. The use of bar codes for these component parts ensures the right resources are supplied at the right time. JIT allows a series of BMW Minis, all of different colours and engine sizes, to be made on the same production line.

Case study 40.2 - FedEx

FedEx Corporation is an American multinational company that specialises in courier delivery services. Established in 1971, FedEx earns annual revenues in excess of $84 billion and employs over 550,000 workers around the world. FedEx gained a first mover advantage by pioneering a tracking system with real-time updates on package location. This enables the company to monitor the delivery process and locate any packages that may be delayed or lost. Customers are also able to see the estimated time of delivery. Today, this feature is also used by most of FedEx's competitors.



Figure 40.3 - JIT relies on an effective stock control management system

Table 40.1 - The advantages and disadvantages of JIT

Advantages of JIT	Disadvantages of JIT
JIT eliminates the costs of holding stock, such as rent (of storage space), insurance, stockpiling and the costs of theft or spoilage (damage) of inventories.	It relies on sophisticated technologies to ensure that the correct stocks are ordered and delivered at the right time and place. Mistakes or malfunctions could bring production to a halt.
As cash is not tied up in stocks, working capital can be better used elsewhere, thereby improving the firm's cash flow position (see Chapter 20).	Administration and transactions costs are higher as just-in-time systems require frequent re-ordering of stocks.
JIT can help firms to reduce their break-even (see Chapter 39), e.g., Rolls-Royce claimed that its annual break-even halved following its use of JIT.	Stocks must be of good quality in order to prevent bottlenecks in the production process. Hence, quality control (see Chapter 37) can become an issue.
JIT allows firms to be more flexible and responsive to the needs of their customers, such as seasonal changes in demand.	There is overreliance on efficient and dependable suppliers. Major problems arise if stocks are not delivered on time.
JIT systems can improve staff motivation by encouraging employee participation and teamwork (both important elements of JIT).	As stocks are only ordered when needed, there are fewer opportunities to exploit economies of scale (see Chapter 5).
JIT reduces wastage; inventory cannot go out of date as there is no buffer stock.	JIT systems prove to be inflexible in trying to cope with a sudden increase in demand.
JIT can help to strengthen a firm's professional relationship with its suppliers, thereby helping to reduce lead times in the production process.	Minimal stock levels mean that there is little scope for mistakes. The need to be 'right first time' can bring added pressures to production staff.
The need for zero defects means there is no need to rework substandard output as JIT promotes a 'right first time' approach to production.	Since JIT is a philosophy, it must be embedded in the organization's culture. It requires the belief, support and commitment of all workers.

Just-in-case (JIC)

Just-in-case (JIC) is the traditional stock control system that maintains large amounts of stock in case there are supply or demand fluctuations. A buffer stock (or reserve stock) of raw materials, semi-finished goods and finished goods is used just in case there are any issues, such as late delivery of stocks from a supplier or a sudden increase in demand for output. Hence, JIC ensures that there is always sufficient stock available to meet customer demands. The advantages and disadvantages of JIC are outlined in Table 40.2.

However, JIC can mean that a business holds too much stock, i.e., overestimates the level of demand for its products. This can cause serious problems for the business. In the 1980s and 1990s, Rover tried desperately to compete with BMW, but the lack of demand led to huge stockpiling of Rover cars and its eventual downfall. This resulted in BMW buying out the Mini brand from Rover, which it has used successfully since 2000, having rebranded it as the BMW Mini.

Table 40.2 - The advantages and disadvantages of JIC

Advantages of JIC	Disadvantages of JIC
JIC allows a business to meet a sudden increase in demand as there is a buffer stock to rely on.	JIC imposes high costs of storage, including the costs of insurance and maintenance.
It reduces down-time (inactivity) caused by a stock-out as there is no need to wait for delivery of stocks to arrive from suppliers.	Some stocks are perishable (so buffer stocks are not feasible) whilst other inventories are subject to damage or theft.
It enables a business to take advantage of purchasing economies of scale (from bulk buying raw materials and components for production).	There is an opportunity cost of money being tied up in stocks, i.e., the money might have been used more profitably elsewhere in the business.

Question 40.2 - IB Café



Blanca Martin-Gil Vecilla owns and runs IB Café as a sole trader in Barcelona, Spain. Sales revenue has been falling and the high level of stocks held at the business is causing cash flow problems. Blanca feels that she is too busy to place orders based on sales forecasts produced by her assistant manager. A further complication is that IB Café's main supplier has suddenly gone out of business, so she will now need to look for a new local supplier.

(a) Define the term *sole trader.* *[2 marks]*

(b) Explain how introducing just-in-time might be suitable for IB Café. *[4 marks]*

(c) Comment on why it might be advisable for IB Café to base its inventory orders on sales forecasts. *[4 marks]*

HIGHER LEVEL

Operations management

Stock control

Stock control charts based on the following: lead time, buffer stock, reorder level and reorder quantity. AO2, AO4.

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Stocks (or **inventories**) are the materials, components and products used in the production process. There are three categories of stocks:

- **Raw materials** - These are the natural resources used for production, e.g., crude oil, metal ores, soil, wheat and timber.
- **Work-in-progress** - These are semi-finished (unfinished) products, e.g., component parts to be used in the production process.
- **Finished goods** - These are complete units of output that are ready for sale, e.g., furniture, books, bread and cars.

Managing stock levels is an important task for all businesses. Without sufficient stock, production and sales will be interrupted. Stock control involves careful planning and control to ensure that sufficient stocks are available and at the right time. Businesses have to decide on the optimal level of stock because there are costs and drawbacks to poor stock control. Both **stockpiling** (holding too much stock) and **stock-outs** (holding insufficient stocks) create problems for a business, as outline in Table 40.3.

Stockpiling can be caused by overproduction and/or falling demand. Alternatively, stockpiling can be deliberate as retail businesses prepare for seasonal peaks in demand, such as on Black Friday and during the Christmas trading period. Whatever the cause or purpose, stockpiling incurs higher costs which can possibly cause liquidity problems (see Chapter 20).



Figure 40.4 - Changing fashion and trends mean that stockpiling can be costly

Case study 40.3 - Barton 1792 Distillery

In 2018, a warehouse at a whiskey distillery in Kentucky, USA collapsed causing around 9,000 of the 20,000 barrels of whiskey to be damaged. Each cask contained about 53 gallons of whiskey. The cost of the damage for Barton 1792 Distillery went beyond the loss of the expensive stock, as the spillage caused pollution in a nearby river, destroying natural habitats and killing hundreds of fish.

Table 40.3 - The costs of poor stock control

Costs of stockpiling	Costs of stock-outs
Storage costs (such as rent, insurance, maintenance and security costs) can be expensive, especially for firms that produce large, bulky and valuable products such as motor vehicles or aircraft.	A damaged corporate image and reputation due to disgruntled customers (caused by late deliveries or inconvenience). This can also harm customer loyalty and goodwill.
Some types of stock may perish or deteriorate, e.g., fresh flowers or food products. Hence holding large volumes of stock can be wasteful and expensive.	Higher administration costs, as the firm needs to place more orders more often. Also, smaller orders do not attract discounts compared to bulk purchases.
Stocks, such as semi-finished goods, can be illiquid yet they consume working capital that could have been better used elsewhere.	Lost sales as stocks are not available to meet customer orders. Worse still, customers might choose to buy from a rival business that does have stock.
Changing fashions and tastes will mean that excess and obsolete stocks need to be heavily discounted in order to offload the products.	Inefficiencies as production comes to a standstill, i.e., machinery and other resources are left idle yet staffing costs and overheads need to be paid.

Question 40.3 - Ford's stockpiling nightmare

At the turn of the millennium, the Ford Motor Company had struggled to remain profitable with huge **stockpiles** of its cars. Ford's continued efforts to cut costs saw the company reduce production by 21% in North America in 2006. By 2008, despite producing over 5.5 million automobiles, Ford had sold off its majority stake in Mazda and luxury brands Aston Martin, Jaguar and Land Rover. Troubles continued for the American automaker and in 2010, Ford had also sold off its stake in Volvo to China's Geely Group.

Ford claimed that the cuts were necessary to remove excess and unprofitable production, despite the negative effects on employees and suppliers. In response to growing competition and the need for better cost control, Ford announced that it would discontinue the production of almost all of its car models in North America by 2020. Instead, the company chose to focus production on vehicles that its customers prefer, such as Sports Utility Vehicles (SUVs) and the timeless Ford Mustang. The strategy seems to have worked, at least for now, with the company earning **profit** of $17.937 billion by the end of 2021

(a) Define the term *stockpiles*. *[2 marks]*

(b) Define the term *net profit*. *[2 marks]*

(c) Examine the costs of poor stock control to Ford Motor Company. *[6 marks]*

Stock control charts (see Figures 40.5 and 40.6) are used to graphically illustrate a simplistic system of stock control in a business. For ease of illustration, stock control charts are usually drawn on the assumption that sales (and hence stock usage) are constant, although they can be easily adjusted to suit the needs of a business.

There are several key ideas behind stock control charts (refer to Figure 40.5):

- **Maximum stock level** - This is the upper limit of stock that a business wishes to hold, determined partly by the physical storage space that is available and the level of demand for output, per period of time.
- **Reorder level** - There is a time lag between a firm placing an order for stocks and them being delivered. Hence, when inventories fall to the re-order level, an order is placed. This helps to ensure that the order arrives just as stocks fall to the pre-set minimum level.

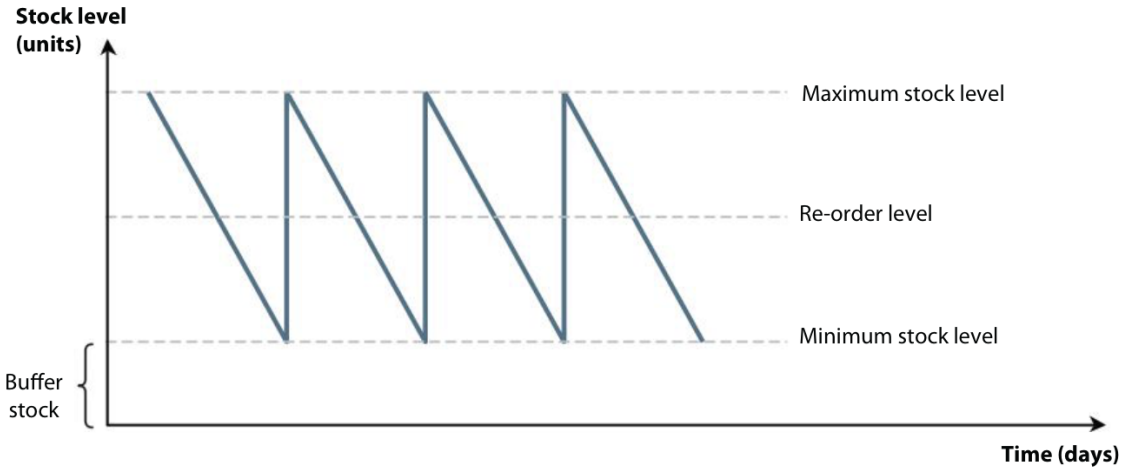


Figure 40.5 - Traditional stock control chart

- **Minimum stock level** (or **buffer stock**) - This is the lowest amount of inventory that a business wishes to hold. Buffer stocks are held as a precautionary measure against any unexpected events, such as late deliveries or a sudden increase in demand. The more efficient the firm, the lower buffer stocks tend to be.

Stock control charts are used to help businesses with their management of stocks. With reference to Figure 40.6, several other features can be seen.

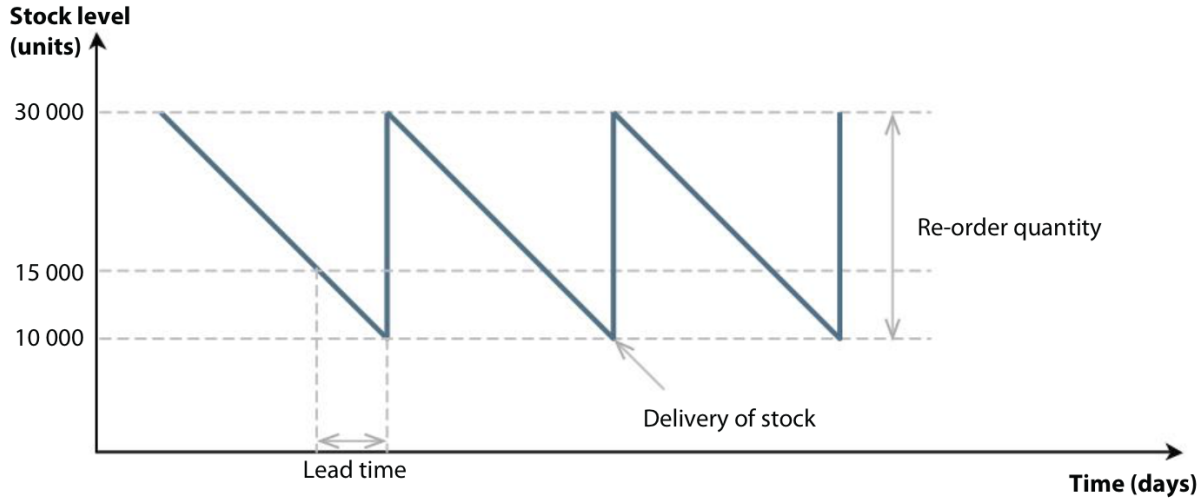


Figure 40.6 - Reorder quantity and lead times

- **Reorder quantity** - This is the amount of new stock ordered. In Figure 40.6, the reorder quantity is equal to 20,000 units (i.e., 30,000 minus 10,000). This order is placed whenever stock levels hit the reorder level (15,000 units in this case).

- **Lead time** - This measures the time lag between placing an order and receiving the stocks. The greater the lead time, the higher the buffer stock level needs to be. Delays can prolong lead times so cause stock levels to go below the desired minimum level. Hence, it is important to have sufficient buffer stocks to deal with unforeseen situations.

- Also, notice from the chart that the level of stocks goes up vertically whenever there is a delivery of stocks. If the correct amount of stocks is delivered on the right day, the increase should bring stocks back to their maximum level.

- In reality, the chart might not be so predictable due to miscalculations, such as late deliveries or the incorrect amount of stocks being delivered. The **usage rate** (the speed at which stocks are depleted) might also be different from originally predicted, resulting in either a stock shortage or stockpiling.

Optimum level of stocks

The ideal or best possible level of stocks for a business varies from one organization or industry to another, e.g., the optimal stock level for a supermarket is quite different from that of a small florist or restaurant. Firms face a dilemma when they order stocks: larger orders generate cost savings through economies of scale (see Chapter 5) but increased storage and maintenance costs. Striking a balance relies on the expertise of managers to establish the **economic order quantity**. This is the optimum stock level that ensures there are sufficient stocks for uninterrupted production, whilst minimizing the costs of holding inventory.

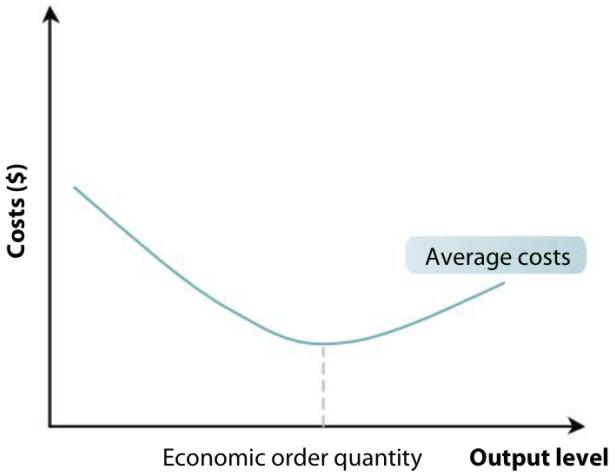


Figure 40.7 - The economic order quantity

Several factors influence the amount of stock a business holds and orders:

- *Type of product* - Fast-moving consumer goods (FMCGs), such as soft drinks and personal hygiene products sold in supermarkets, are reordered in large quantities. This is because by the time that new stocks are delivered, the firm would have sold many more units of the FMCGs. Conversely, consumer durables such motor vehicles, furniture or consumer electronics, have a lower stock usage rate so will be reordered in much smaller quantities. Unlike FMCGs, stockpiles of perishable products (such as fresh flowers and seafood) would be disastrous for a business.

- *Expected level of demand* - The higher the level of demand, the greater the amount of stock needed. A supermarket will stock more of the better selling brands on its shelves. Car showrooms will stock more of their relatively cheaper, better selling models. Stock levels rise during peak trading periods, such as barbeque products during the summer and decline again during off peak seasons.

- *Lead times* - Suppliers that can guarantee short lead times allow a business to have minimal buffer stocks. Conversely, larger volumes of stock need to be reordered if there are long lead times, such as shipment of heavy and bulky products from an overseas supplier.

- *Costs of holding stock* - The higher the opportunity cost of stockpiling, the lower the optimal stock level tends to be. It can be costly for a luxury car producer or jeweller to hold excess stock of its most expensive brands and products (due to the limited demand for these and the risks of theft or damage). By contrast, the pace at which low-cost FMCGs are sold allows retailers to hold large volumes of stock.



Figure 40.8 - Stockholding of perishable products such as fresh flowers can be very costly

Large businesses use computerised stock control systems that enable them to manage stocks from hundreds of product lines without workers having to manually count the inventory (which would be a horrendous task for large retailers such as Walmart, Costco, Tesco and Carrefour). For example, each time a barcode on a product is scanned at the checkouts, the computerised system updates the level of stocks. When the stock level reaches the reorder level, the computer system automatically places an order. It is common for the more popular product lines in supermarkets to be replenished several times a week.

With more sophisticated computerized systems, it is possible to input data such as public holidays and festivals to determine the optimal stock level at different times of the year, such as Christmas, New Year, Valentine's Day, Mothers' Day, Diwali, Fathers' Day, summer holidays, 'Back to School' season, Halloween and so forth. Being able to stock the right products at the time when consumers want them can certainly help to give the business a competitive advantage. It is also useful to know which of the less popular products should be discontinued (since they take up shelf space without the expected sales revenues).

HIGHER LEVEL

Operations management

Theory of Knowledge (TOK)



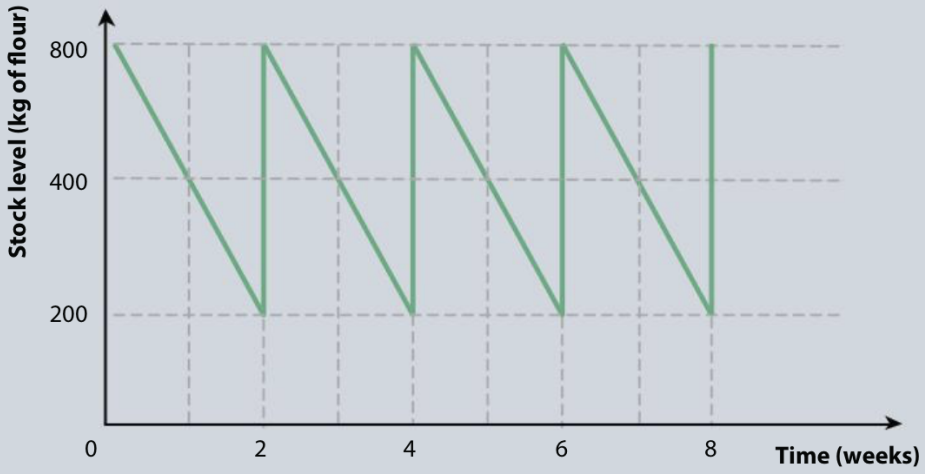
How do retailers know how many 'Happy Wedding Anniversary' gift cards to keep in stock?

Business Management Toolkit

Discuss the role of descriptive statistics (see Chapter 50) and simple linear regression (see Chapter 58) in production planning.

Question 40.4 - Diallo Bakery

Diallo Bakery is a profitable business that produces bread and cakes for several large supermarket chains in the local area. However, the production manager, Youssouf Diallo, thinks that the business holds too much stock (see chart below), so this has limited its growth and profits. Youssouf Diallo has produced the following stock control chart to present at a management meeting, alongside his proposals for introducing a **just-in-time** stock management system.



(a) Define the term *just-in-time*. *[2 marks]*

(b) Use the stock control chart prepared by Youssouf Diallo to identify Diallo Bakery's:

(i) Re-order level
(iii) Buffer stock
(ii) Re-order quantity
(iv) Lead time. *[4 marks]*

(c) Explain why a supermarket is likely to have a higher reorder quantity than Diallo Bakery. *[4 marks]*

(d) Examine Youssouf Diallo's proposal to use just-in-time production system. *[6 marks]*

Capacity utilization

Capacity utilization rate. AO2, AO4

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Capacity utilization measures a firm's existing level of output as a proportion of its potential output. A high capacity utilization rate means that the level of output is close to its maximum (known as the **productive capacity** or **potential output**). The capacity utilization rate is calculated by using the following formula:

$$\text{Capacity utilization} = \frac{\text{Actual output}}{\text{productive capacity}} \times 100$$

For example, if a firm's maximum possible output is 10,000 units per month, but it actually produces 8,500 units, then its capacity utilization rate is 85%.

Hence, the capacity utilization rate is a measure of a firm's efficiency as it reveals the extent to which there are idle (unused) resources in the organization. High capacity utilization is financially important as it spreads out fixed and indirect costs of production over a large level of output (see Chapter 15).

High capacity utilization is likely to be relatively more important to businesses that have:

- *High fixed costs* – The higher a firm's capacity utilization, the lower the average fixed costs (AFC) will be. For example, suppose a firm has fixed costs of $10,000 and a productive capacity of 2,000 units per month. It would have AFC equal to $10 if output was 1,000 units. However, if it operates at full capacity, the AFC would halve to just $5 ($10,000 ÷ 2,000 units).

- *Low profit margins* – Products with low profit margins contribute little (per unit) to the profits of a business so need to be sold in large quantities to be profitable. Mass market products such as FMCGs have low profit margins, but the high volume of sales can generate plenty of profit.

- *High levels of break-even* – Similarly, high capacity utilization is needed if a firm has a high break-even quantity (see Chapter 39). This might be due to exceptionally high production costs (such as aircraft manufacturing) or because products have low profit margins (thus limiting the unit contribution and raising the break-even level of output).

- *Low marginal costs* – If the extra cost of providing a particular good or service to an additional customer is close to zero, then high capacity utilization will be important for profitability. Airlines, schools, theme parks, cinemas, hotels, coffee shops, car park operators and downloadable apps all fall into this category.



Figure 40.9 - High capacity utilization is important for airlines

Costs are incurred 24 hours a day. For example, a restaurateur needs to pay rent, insurance and salaries, no matter how busy the restaurant is. Empty tables represent spare capacity and a burden on costs. Idle resources not only represent wastage and inefficiency but are also a drain on finances. Hence, schools often rent out their facilities in the evenings, at weekends and during the school holidays to generate extra revenues. For employees, low capacity utilization is a concern as it often leads to higher unemployment. Box 40.1 outlines various ways that a firm can increase its capacity utilization.

Box 40.1 - Methods to increase capacity utilization

- *Improved marketing strategies* – Increased sales automatically lead to higher capacity utilization. Of course, spending more on marketing does not necessarily generate more sales, as there are many other factors that influence the level of demand for a product, such as consumer income levels and the availability and price of substitutes.
- *Subcontract work* – This involves using external firms to help supply the firm's products (see Chapter 38). The main drawback is that profit margins are likely to be lower (if prices are kept constant) or prices need to be raised (to maintain profit margins, but this can reduce the demand for the firm's products).
- *Reduced capacity* – Spare capacity might exist because of excess capacity. General Motors, Ford and Dell have closed down operations in the past to reduce excess capacity. Whilst this causes job losses in the short- term, it is often necessary for the firm's profitability in the long-term.

Exam tip !

There is little that the firm can do if the cause of low capacity utilization is an economic recession. When the economy recovers, capacity utilization should automatically increase to meet the increasing level of consumer demand.



Figure 40.10 - High capacity utilization is important for car park operators

Although there are significant benefits of working near or at full capacity, there are also potential drawbacks. As the English proverb goes, "A full cup must be carried steadily", i.e., operating at full capacity brings its own burdens and potential drawbacks. The disadvantages of high capacity utilization include:

- High capacity utilization requires equipment and machinery to be used continually, without there being any time for routine servicing and maintenance. This is likely to lead to future breakdowns, which will delay output.
- Operating at full capacity can overburden workers. This can be counter-productive, especially if staff are constantly required to work overtime, tired and stressed. Thus, the quality of output is likely to suffer.
- For service providers such as theme parks, restaurants or hair salons, operating at or near full capacity can lead to all sorts of problems, such as longer waiting times and lower standards of customer service. There might also be health and safety concerns, such as overcrowding.
- High capacity utilization is not a substitute for organizational growth. For a business to take on more orders to meet rising levels of demand, it needs to expand the scale of production, i.e., raise its productive capacity. This will, however, require additional funding and can be rather expensive.

Common mistake

Do not confuse the drawbacks of higher capacity utilization with diseconomies of scale (see Chapter 5). The above disadvantages occur when a business operates near or at its productive capacity. Diseconomies of scale can only happen if the business operates on a larger scale, i.e., if its productive capacity (potential output) has increased.

Exam tip !

It is important to consider the *context* of the business when deciding whether it should increase or decrease its capacity utilization. For example, a product in the launch phase of its life cycle is likely to have low capacity utilization. Only if demand for the product surges will the firm increase its capacity utilization.

Box 40.1 - Methods to increase capacity utilization

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Question 40.5 - The Emirates Stadium, London



The seating capacity at Arsenal Football Club's Emirates Stadium is 60,260 making it one of the largest stadiums in England. Wembley Stadium, England's national football stadium, is the largest with a seating capacity of 90,000. On a typical home fixture at The Emirates Stadium, the North London football club sells 59,957 tickets. However, the highest attendance recorded was 60,161 in a match against Manchester United.

(a) Calculate the average capacity utilization rate at The Emirates Stadium. *[2 marks]*

(b) Explain the importance to Arsenal Football Club of operating at close to the stadium's capacity. *[4 marks]*

Question 40.6 - Virginie Srienz Inc.

Use the following data for Virginie Srienz Inc. (VSI) to answer the following questions:

- Total fixed cost = $10,000 a month
- Productive capacity = 30,000 units
- Demand = 20,100 units
- Average variable costs = $5
- Price = $15

(a) Calculate VSI's capacity utilization rate. *[2 marks]*

(b) Calculate VSI's average costs of production at 20,100 units and 30,000 units of output. *[3 marks]*

(c) Calculate the profit margin for VSI at its current output and at its full capacity level of output. *[3 marks]*

(d) Calculate the percentage change in VSI's total profit if it increases sales from its current level to its potential output. *[4 marks]*

HIGHER LEVEL

Operations management

Question 40.7 - AMC Theatres



AMC Theatres (or AMC Cinemas, as it is known in some parts of the world) is the world's largest chain of cinemas. AMC Theatres was the first American cinema chain to expand operations into foreign countries.

When movies are being screened, the marginal cost of an extra customer is close to zero. Hence, cinemas rely heavily on high **capacity utilization**. However, overcapacity might bring even greater problems for AMC Theatres if it has to turn away some customers for highly popular movies.

(a) Define the term *capacity utilization*. *[2 marks]*

(b) Outline why the "marginal cost of an extra customer [at the cinema] is close to zero". *[2 marks]*

(c) Examine the importance of high capacity utilization rates for AMC Theatres. *[6 marks]*

Exam tip !

Businesses do not generally aim to operate at maximum capacity. Quite often, they choose to operate below their full capacity in order to improve the overall level of customer service and not to overburden their workers. Whilst a higher capacity utilization rate has its benefits, operating at full capacity certainly has major drawbacks.

Defect rate (AO2, AO4)

Defects occurs when the quality of a particular product is unacceptable (i.e., substandard). This means the product does not meet the required quality standards but has faults or imperfections. Defects represent waste and inefficiency. The **defect rate** measures the proportion of output, per time period, that is substandard. Defect rates can be used to evaluate production process and is a measure of quality assurance. The formula for calculating the defect rate is:

$$\text{Defect rate} = \frac{\text{Defect output}}{\text{Total output}} \times 100$$

For example, suppose a firm produced 10,000 units of output of which 150 units were substandard as they did not meet the firm's quality standards. This means the firm has a defect rate of 1.5%. The higher the defect rate, the lower the quality of output.

In reality, it is not always feasible or necessary to measure the defect rate as a proportion of total output. For example, a bike manufacturer might use quality controllers to test the functionality of 100 bicycle is chosen at random. The defect rate is then calculated using the following formula:

$$\text{Defect rate} = \frac{\text{Defected units}}{\text{Number of units tested}} \times 100$$

Box 40.2 - CAD and CAM

Many manufacturing firms use CAD and CAM technology to help achieve zero defects.

- **Computer Aided Design (CAD)** is the process of using dedicated computer hardware and software in the design process, such as 3-dimensional designs of products (such as cars or home furniture). CAD software enables a wider range of designs to be completed and in a much quicker timeframe.
- **Computer Aided Manufacturing (CAM)** uses sophisticated automation and machinery in the production process. CAM is far more superior to human input in terms of both speed and accuracy of output.

Case Study 40.4 - Car problems

- In late 2013, Volkswagen (VW) recalled over 640,300 vehicles due to oil problems. The European carmaker also recalled a staggering 2.6 million cars worldwide due to lighting engine oil problems.
- In early 2014, General Motors recalled 1.46 million cars due to a safety issue with the fuel pumps in its Buick and Chevrolet cars.
- Ford also recalled 81,000 of its Kuga cars due to steering problems in 2014.
- In 2017, VW recalled more than 600,000 vehicles in the USA due to defects that could result in fires or airbag malfunctions.
- In early 2021, VW recalled around 56,000 new cars due to non-functional backup (reverse) cameras.
- In 2018, Tesla recalled 123,000 Model S cars worldwide due to steering problems. In 2021, Tesla had to recall almost 12,000 vehicles due to a glitch in the full self-driving software. In 2022, Tesla had to recall nearly 54,000 vehicles because of a faulty software feature that may let their vehicles roll past stop signs.

To determine whether a particular defect rate is acceptable, context is important (see question 40.4 – Durex). It is also important to benchmark a firm's defect rate in relation to industry norms and averages. Like the concept of kaizen (see Chapter 37), benchmarking cannot be a one-off exercise if an organization is to achieve quality assurance and zero defects. As Greek philosopher Aristotle put it "Quality is not an act, it is a habit". To be effective, benchmarking has to be a continuous process that involves the commitment and involvement of every employee. This allows the firm to gain lasting improvements in quality, including a reduction in defect rates.

Many businesses pursue a Six Sigma lean production strategy to increase quality by striving to limit defects to no more than 3.4 imperfections per million units of output (the statistical value of Six Sigma), i.e., a success rate of 99.99966% free of any defect. In essence, it is a systematic approach to achieving near perfection or zero defects. Companies that have used this strategy include Motorola, Boeing, General Electric (GE), Ford, Apple and Bank of America. Motorola announced a saving of over $17 billion during the first 20 years of using the Six Sigma strategy. Similarly, GE estimated a saving of $10 billion during its first 5 years of using the strategy.

Question 40.8 - Durex

Durex is the world's most popular brand of condoms. Reckitt Benckiser, the British multinational company that produces Durex condoms, has around 25% of the world market share, with output of over 1 billion units each year. The Durex brand name is short for Durable, Reliable and Excellence. Each Durex condom can hold up to 40 litres of air or 9 gallons of water, before bursting. Samples, including condoms that have been artificially aged, are tested to destruction for physical strength. The Durex factory in Bangkok, Thailand reports a greater than 97% pass rate. Thailand is the world's leading exporter of condoms, with an annual output of over 300 million units from the Durex factory alone.

Source: adapted from www.durex.com

(a) Calculate the approximate quantity of defective Durex condoms produced each year at the Bangkok factory. *[2 marks]*

(b) Explain why quality assurance is crucial to multinational companies such as Reckitt Benckiser. *[4 marks]*

(c) Comment on how Total Quality Management (TQM) might help Reckitt Benckiser to reduce its defect rate of Durex condoms. *[4 marks]*

HIGHER LEVEL

Operations management

Productivity

Labour productivity, capital productivity, productivity rate and operating leverage. AO2, AO4

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Productivity refers to how well resources, such as labour or capital, are used in the production process. Resources are also known as factor inputs or just inputs. These are used to produce goods and services, although the productivity determines the amount actually produced (the output), as illustrated in Figure 40.11).



Figure 40.11 - The relationship between input, productivity and output

The **productivity rate** measures the degree of efficiency in the use of resources in the production process. It is calculated by using the following formula:

$$\text{Productivity rate} = \frac{\text{Total output}}{\text{Total input}}$$

For example, **labour productivity** is a measure of the efficiency of the workers by calculating the output per worker. The formula for calculating labour productivity is:

$$\text{Labour productivity} = \frac{\text{Total output}}{\text{Number of workers}}$$

For example, if a real estate firm has 10 employees who collectively sell property to the value of $2.5 million this month, the labour productivity rate (or output per worker) is equal to $250,000. An alternative measure to using the number of workers is to calculate labour productivity by dividing the total output by the total number of labour hours (output per hour worked). In any case, the higher the labour productivity rate, the more productive (or efficient) the workers are.

Capital productivity measures how well a firm uses its physical capital, such as machinery, in order to produce goods and services. The formula for calculating capital productivity is:

$$\text{Capital productivity} = \frac{\text{Total output}}{\text{Number of capital hours}}$$

Capital input is usually measured in hours, such as the number of machine hours used to produce a certain amount of output. For example, if a firm operates machinery in its factory for 700 hours this month and produced 2.24 million units of output, the capital productivity rate is (2.24m / 700) = 3,200 units per machine hour.

Higher productivity rates are important to businesses for several reasons, which can be remembered using the '4 Es' - these are the advantages of productivity:

- **Economies of scale** (cost savings) - Higher levels of productivity and hence output help to reduce the average costs of production. The cost savings can be passed onto customers by reducing prices, e.g., the mass production of smartphones, tablet computers and flat-screen televisions has made these goods much more affordable to customers across the world. Cost savings from a higher productivity rate can also help businesses to gain a greater profit margin on each product sold.



Figure 40.12 - Consumer electronics are mass produced and shipped worldwide

- **Earnings** (higher profits and wages) - Higher productivity rates are a source of cost savings and higher profits for businesses. Higher profitability enables firms to also pay higher wages to their workers who are more productive. Competitive wages can help to attract higher calibre employees. Higher profits can be reinvested back into the business to fund research and development (see Chapter 42) or used to expand its operations.

- **Efficiency** (improved competitiveness) - Highly productive businesses can gain advantages beyond economies of scale. As they are more productive, they can compete more effectively on an international scale. For example,

Samsung's productivity gains during the early 2000s meant the company overtook Apple to become the market leader of smartphones.

- **Evolution** (growth) - The combined benefits of the above mean that a higher productivity rate is a source of growth for businesses because it increases their productive capacity. For example, huge productivity gains at Google have made the Internet giant one of the world's largest businesses.

Common mistake

Students often confuse higher levels of production with higher productivity rates. The former increases the output of goods and services. However, increasing the number of workers or any other resource (factor input) does not necessarily increase output unless they are used productively (efficiently). Businesses that operate on a larger scale can suffer from *diseconomies* of scale (see Chapter 5), resulting in a lower productivity rate.

Determinants of productivity rates

The five key determinants of productivity rates can be remembered using the acronym 'TRIES':

- **Technology** - In general, investment in the latest technologies helps workers to be more productive, i.e., to produce more output that is of better quality. Information communications technology (ICT) has also enabled firms to operate globally, irrespective of time zone differences.
- **Rivalry** - Competition creates an incentive for businesses to be more productive in order to remain competitive. Without some degree of rivalry, businesses might lack the incentive to be efficient or innovative.
- **Innovation** - This is the commercialization of new ideas and products. Innovative products such as tablet computers and smartphones have changed the way many people work as they are able to work whilst mobile rather than at the office, thereby increasing labour productivity.

Question 40.9 - Measuring productivity

TThe figures below relate to two real estate firms that sell residential property, Gupta Realty Ltd. and Jenkins Realty Co.

Firm	Sales revenue ($)	Units sold (per week)	Sales staff
Gupta Realty Ltd.	15,450,372	54	18
Jenkins Realty Co.	13,075,560	60	16

(a) Calculate the labour productivity rate using sales revenue per worker for both Gupta Realty Ltd. and Jenkins Realty Co. *[3 marks]*

(b) Using the above figures, explain why it might be difficult to conclude whether Gupta Realty Ltd. or Jenkins Realty Co. is the more productive firm. *[4 marks]*

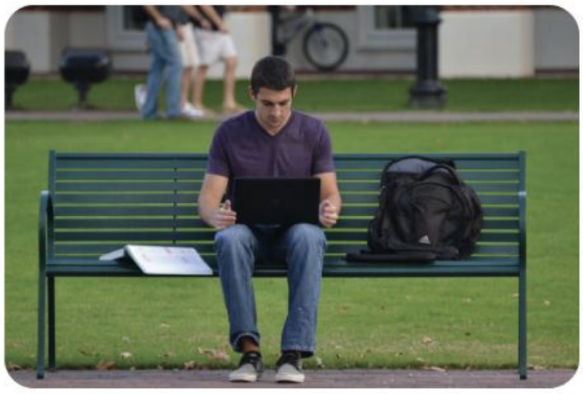

Figure 40.13 - Technological innovations have changed the way we work

- **Entrepreneurship** - Entrepreneurs take calculated risks in the pursuit of profit. A firm's productivity rate is largely dependent on the leadership and personal motivation of entrepreneurs, such as their willingness and ability to exploit new business opportunities in an ever-changing business environment.

- **Skills and experience** - The labour productivity rate is determined by the quantity and quality of labour. Education, training and development can increase a firm's human capital (the skills and experiences of the workforce), further improving labour productivity.

Exam tip !

Remember that Business Management is an interrelated discipline, e.g., non-financial rewards, such as recognition of workers' achievements (see chapter 10), can positively impact the labour productivity rate. Consider how genuine praise from your teachers or parents can influence your attitude to learning!

ATL Activity (Communications and Thinking skills)

How can you improve your productivity rate in the IB Diploma Programme? Share your suggestions with the rest of the class and determine which ideas best suit your own preferred learning style.

However, in the pursuit of achieving a higher productivity rate, there can be unnecessary pressures and stress imposed on workers. Such burdens can cause a decrease in quality and staff morale. Thus, there comes a point when reaching a higher productivity rate actually costs a business more money.

Question 40.10 - Social media and productivity

The Associated Chambers of Commerce and Industry recently found that employees in India spend an average of one hour a day (during office hours) on social network websites such as Facebook and Twitter, causing a 12.5% decline in **labour productivity**. In total, 4,000 employees were surveyed across 60 cities in India with over 40% of respondents admitting to building their entire social network profile at work.



Similar findings were reported in *The Daily Telegraph*, which highlighted that **social networking** websites cost the British economy a staggering £14 billion ($20.3bn) a year in lost output of work. Over 2 million workers admitted to wasting over an hour each day at work adding friends, uploading photos and videos and sending tweets.

(a) Define the term *labour productivity*. *[2 marks]*

(b) Define the term *social networking*. *[2 marks]*

(c) With reference to the case study, examine the costs of low productivity for businesses. *[6 marks]*

Operating leverage

Operating leverage measures a firm's fixed costs as a percentage of variable costs. A firm with relatively high fixed costs is said to have high operating leverage. This may have detrimental impacts on break-even and profits if sales fall, perhaps due to an economic recession. This is because the firm must achieve sufficient sales volume to cover its considerable value of fixed costs. In this case, the firm earns a large contribution on each additional sale but must achieve sufficient sales volume to cover its substantial fixed costs. Examples of businesses with high operating leverage include pharmaceuticals, oil and energy, airlines and telecommunications. For example, the bulk of Microsoft's cost structure is fixed for upfront expenditure on research, development and marketing costs. Whether Microsoft sells just one copy or 100 million copies of its latest Windows Office software, the company's fixed costs essentially remain unchanged. Once it has sold enough copies to reach break-even (by covering its fixed costs), incremental sales generate profits for the company.

As fixed costs need to be paid, regardless of output or sales, businesses will want to operate near their productive capacity. This helps to spread the fixed costs over more units of output and sales, thereby reducing the fixed cost per unit.

Operating leverage is calculated by using the following formula:

$$\text{Operating leverage} = \frac{(\text{Price} - \text{Variable cost per unit}) \times \text{Quantity}}{[(\text{Price} - \text{Variable cost per unit}) \times \text{Quantity}] - \text{Fixed costs}} \times 100$$

Or

$$\text{Operating leverage} = \frac{\text{Total contribution}}{\text{Profit}} \times 100$$

By contrast, a firm that has low operating leverage means fixed costs are relatively low compared to variable costs. In this case, the firm does not have to generate much sales volume in order to cover its fixed costs. If sales volume fall, again perhaps due to an economic recession, so will variable costs (which account for a larger proportion of costs for the firm). It is easier for this type of business to earn a profit on low sales levels. Hence, this represents lower risk, but it must rely on high sales volumes to generate large profits. Examples of businesses with low operating leverage include consultancy services, cafés, hair salons and e-commerce.

For example, suppose Anna Eglin Consultancy (AEC) has total sales revenue of $100,000, total variable costs of $30,000 and total fixed costs of $60,000. Intuitively, we notice that AEC has high operating leverage as the fixed costs are relatively higher than the variable costs. Nevertheless, AEC's operating leverage is calculated as follows:

- Total contribution = $100,000 – $30,000 = $70,000
- Fixed costs = $60,000
- Operating leverage = $70,000 / ($70,000 – $60,000) = 7.0
- This means that a 10% increase in sales volume will yield a 70% increase in profits.

Question 40.11 - Bath & Body Works Inc.

In 2020, Bath & Body Works Inc. announced the closure of numerous retail locations, including 250 of its Victoria's Secret stores, following the COVID-19 pandemic. The company blames the high fixed costs of operating retail stores without the revenue from customers due to national lockdowns and widespread job losses, causing the company to have high **operating leverage.**

The closures accounted for nearly 25% of all retail locations of Victoria's Secret, the USA's largest lingerie retailer. Bath & Body Works Inc. said the decision would deliver $400 million in savings and improve the company's profit margins. In 2021, Bath & Body Works Inc. had sold off 55% of its stake in Victoria's Secret whilst keeping the remaining 45% stake in the multi-billion-dollar company.

(a) Define the term *operating leverage.* *[2 marks]*

(b) Explain the decision of Bath & Body Works Inc. to sell off Victoria's Secret. *[4 marks]*

HIGHER LEVEL

Question 40.12 - Nicola D'ambrosio Manufacturing Corp

Nicola D'ambrosio Manufacturing Corp. (NDMC) produces construction material. The company has total fixed costs of $750,000. The selling price is $30 and its **variable cost per unit** is $15. NDMC sold 250,000 units throughout the year.

(a) Define the term *variable cost per unit.* *[2 marks]*

(b) Calculate the operating leverage for NDMC. *[3 marks]*

(c) Comment on your findings to the above question. *[2 marks]*

Cost to buy (CTB) and Cost to make (CTM)

Cost to buy (CTB) and Cost to make (CTM). AO3, AO4

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A business faces a **make-or-buy decision** when it has a choice between manufacturing a product or purchasing it from an external supplier. There are several quantitative methods that can aid this decision. Examples include investment appraisal (see Chapter 21) and break-even analysis (see Chapter 39). However, the main quantitative method for make-or-buy decisions is to consider the relative costs of manufacturing the product (known as the **cost to make**) and the costs to purchase the product from a third-party supplier (known as the **cost to buy**).

If the cost of producing the product is lower than the supplier's price, it makes financial sense to make the product rather than to buy it and vice versa. For example, Apple considered its cost to make the iPhone to be significantly higher than to use Foxconn in China to manufacture the product, i.e., the cost-to-buy (CTB) from Foxconn is lower than Apple's cost to make (CTM).

The 'buy' decision should go ahead if a business does not have the expertise, equipment or productive capacity to efficiently manufacture a product. As with outsourcing or subcontracting (see Chapter 38), non-core functions can be contracted to third-party suppliers. If the firm is financially better off by making the product itself, then the 'make' decision is pursued, i.e., these activities are part of the organization's core competencies.

When deciding whether to make or buy, four key variables must be known:

- The expected sales volume or quantity (Q).
- The total fixed costs (TFC) associated with making the product, e.g., tools, equipment and machinery.
- The average variable costs (AVC) of making the product, e.g., wages and material costs.
- The price per unit (P) charged by the supplier.

In order to decide whether to make or to buy, a firm needs to work out the values of both the cost to make and the cost to buy:

- $CTB = P \times Q$
- $CTM = (AVC \times Q) + TFC$

If CTM is greater than CTB, then it is more financially desirable to 'buy'. Conversely, if the CTB is greater than CTM, it makes financial sense to 'make'. Hence, it can be concluded that:

- If the CTB < CTM, the organization will outsource the work to subcontractors
- If the CTM < CTB, the organization will use insourcing (in-house production).

Case study 40.5

Foxconn is the global market leader in the electronics contract industry. The multinational company with its headquarters in Taiwan makes some of the world's best-known electronic products for its clients, including Apple (iPad and iPhone), Amazon (Kindle), Sony (PlayStation), Microsoft (Xbox One) and Nintendo (Switch). Other clients include Acer, Cisco, Dell, Google, HP, Microsoft, Nokia, Toshiba and Xiaomi. Foxconn has factories in Brazil, China, the Czech Republic, Hungary, India, Japan, Malaysia, Mexico and Slovakia.

Exam tip ! Worked example

Question: Suppose a firm is deciding whether to buy or make 1,000 wooden storage sheds. Suppliers could offer the product at a price of $200 per unit. However, there is sufficient capacity for the firm to produce these with direct costs estimated to be $120 per shed and allocated fixed costs of $32,000. Calculate whether the firm should make or buy the wooden storage sheds on financial grounds.

Answer:

- CTB = $200 × 1,000 = $200,000
- CTM = $32,000 + (1,000 × $120) = $152,000



Therefore, based on the limited information, it makes financial sense for the firm to make the products (thereby saving itself $48,000).

Qualitative factors are also usually considered with make-or-buy decisions, such as:

- The relative product quality if produced in-house compared with an external supplier.
- The timeframe in which the products can be produced in-house compared with buying them from an external vendor (seller).
- Whether the business has spare capacity to meet extra orders.
- The reliability of suppliers, e.g., their track record and reputation for delivering products on time.
- An assessment of the firm's core competencies and its non-core functions, e.g., suppliers might have greater design flexibility and access to better technologies.
- Whether the decision is irreversible, i.e., the terms and conditions of the contract.

Question 40.13 - To make or to buy? That is the question

Brothers Luke and Jake are about to celebrate their 4th and 6th birthdays next month. They have asked for a train table for their collection of wooden toy trains. Their father, Ned, has found only one retailer in the town that sells the product, made out of high-quality solid wood at a price of $155. However, the design is very bland and rather simplistic, so Ned feels that his boys might not like the design. If he were to make a similar product, he could personalise the train table for his sons. Ned has estimated that if he chooses to make the train table, the cost would be approximately $80 for all materials plus about fifteen hours of his time. He has yet to calculate the **cost to make** and the **cost to buy**.

(a) Define the term *cost-to-make*. *[2 marks]*

(b) Define the term *cost-to-buy*. *[2 marks]*

(c) Recommend to Ned whether he should make or buy the train table. Use both quantitative and qualitative considerations in your answer. *[10 marks]*

HIGHER LEVEL

Question 40.14 - A. Friend Inc.

Anthony Friend runs A. Friend Inc., a clothes manufacturer. The company has a **make-or-buy decision**. It can purchase new capital equipment at a cost of $15,000 for in-house production of t-shirts for $1 each. Alternatively, a local supplier can produce the t-shirts for A. Friend Inc. for a price of $1.5 each. Demand for the t-shirts is forecast to be 25,000 units.

(a) Define the term *make-or-buy decision*. *[2 marks]*

(b) Calculate the cost to make and the cost to buy and comment on whether A. Friend Inc. should make or buy the t-shirts. *[4 marks]*

Production planning and the key concepts

Production planning is vital for a business to improve its operational efficiency and cost control in an ever-changing business world. This can give the firm a competitive advantage, especially if it is able to pass on some of the cost savings to customers in the form of lower prices. Effective stock control also helps to ensure production can meet the changing demands of customers, thereby contributing towards customer satisfaction and brand loyalty (see Chapter 27).

Managers need to establish the optimum stock level for their organization. Insufficient stocks will lead to production problems, which will disappoint customers. However, overstocking (stockpiling) can lead to cash flow problems due to storage and other related costs (see Chapter 15) and is unsustainable. Establishing the optimal level of stock is not an easy task, especially for businesses facing continual changes, so this often relies on an element of trial and error.

Most firms find it difficult to know the exact amount of stock to hold at any one point in time, so will often hold a buffer stock as part of their strategy. This acts as a safety net just in case there are unforeseen or problematic changes such as a sudden surge in demand or late delivery of stocks due to logistical issues. How firms decide on what their minimum stock level should be is another matter. The decision will depend on several factors such as the type and size of the business, its organizational culture, the level of demand, lead times with suppliers, the costs of holding stock and changes in the market demand for the product.

Changes in domestic and international competitive pressures have led many firms to focus their strategy on cost competitiveness, often by outsourcing and offshoring strategies (see Chapter 38). For example, many large multinational companies have to take on 'make-or-buy' decisions, i.e., deciding whether to make the products themselves or to purchase these from a lower cost supplier. Outsourcing provides many opportunities for businesses in terms of cost control, access to stocks and productive efficiency gains. For example, a business working at full capacity or experiencing rapid growth can continue to expand its operations by subcontracting (see Chapter 38). However, a successful outsourcing strategy requires proactive involvement and commitment from both parties given the dynamic and changing nature of the external business environment.

Effective production planning is based on the notion that higher levels of productivity lead to improved competitiveness and profits. However, stock control is just one of many ways that a firm can achieve greater productivity and lean production (see Chapter 37). Other methods to achieve productivity gains include changes to staff training and development programmes (see Chapter 10), improved staff motivation, enhanced quality management and reduced wastage (see Chapter 37). These points highlight the integrated nature of Business Management. Nevertheless, careful production planning and control are vital to sustaining the competitiveness of a business. As US Army General George S. Patton (1885 - 1945) said, "A good plan today is better than a perfect plan tomorrow." In today's fast-paced, frequently changing business world, even the 'perfect' production plan that is poorly timed will often prove too little too late.

Business Management Toolkit

How can knowledge of changes in the external business environment (see Chapter 46) create both opportunities and threats for production planning?

Key concept

With reference to an organization of your choice, discuss the roles of **change** and **sustainability** in production planning.

REVIEW QUESTIONS

1. What is meant by production planning?
2. What is meant by the supply chain process?
3. What is supply chain management?
4. What is a global supply chain?
5. Why are all businesses in the supply chain said to be interdependent?
6. What is just-in-time (JIT) stock control?
7. What is just-in-case (JIC) stock control?
8. What are the advantages and drawbacks of using a JIT stock control system?
9. What are the advantages and drawbacks of using a JIC stock control system?
10. What are the three categories (or types) of inventories?
11. What are the costs of holding too much stock or stockpiling?
12. Why can a stock-out be costly to a business?
13. What is a stock control chart?
14. Why do businesses hold a maximum and a minimum stock level (buffer stock)?
15. How does the re-order level differ from the re-order quantity?
16. What is meant by an optimal stock level (economic order quantity)?
17. What is the difference between a firm's productive capacity and its capacity utilization?
18. What is meant by a defect rate?
19. What is meant by productivity?
20. How is labour productivity calculated?
21. How is capital productivity calculated?
22. What are the main determinants of productivity?
23. What is meant by operating leverage?
24. What is a 'make or buy' decision?
25. How does the cost to buy (CTB) differ from the cost to make (CTM)?

KEY TERMS

Buffer stock refers to the minimum stock level held by a business in case there are unexpected events, e.g., late deliveries of components or a sudden increase in demand.

Capacity utilization measures a firm's existing level of output as a proportion of its potential output.

Capital productivity measures how well a firm uses its physical capital in order to produce goods and services.

The **cost to buy** (CTB) refers to the expenses or expenditure to purchase a product from a third-party or outsourced supplier.

The **cost to make** (CTM) refers to the expenses or expenditure required to manufacture a good or service in-house.

The **defect rate** measures the proportion of output, per time period, that is substandard.

The **economic order quantity** is the optimum stock level that ensures there are sufficient stocks for uninterrupted production whilst minimizing the costs of holding inventory.

Global supply chains refer to the networks that span multiple countries and regions for the purpose of sourcing and supplying goods and services.

Just-in-case (JIC) is the traditional stock control system that maintains large amounts of stock in case there are supply or demand fluctuations.

Just-in-time (JIT) is a stock control system based on stocks being delivered as and when they are needed in the production process.

Labour productivity is a measure of the efficiency of a firm's workers by calculating the output per worker.

Lead time measures the duration between placing an order and receiving it. The longer the lead time, the higher buffer stocks tend to be.

Make-or-buy decisions refer to situations where a firm has to decide between manufacturing a product and purchasing it from a supplier, based on comparing the cost to make (CTM) with the cost to buy (CTB).

Maximum stock level refers to the upper limit of inventories that a firm wishes to hold at any point in time.

Minimum stock level refers to the lowest amount of inventories that a business wishes to hold as a precautionary measure.

Operating leverage measures a firm's fixed costs as a percentage of variable costs. A firm with relatively high fixed costs is said to have high operating leverage.

Production planning refers to the management process of ensuring sufficient resources (inputs) are available for use to create finished products (outputs) in a timely manner to meet the needs of customers.

Productive capacity refers to a firm's maximum (potential) output if all its resources are used fully and efficiently.

Productivity refers to how well resources, such as labour or capital, are used in the production process.

The **productivity rate** measures the degree of efficiency in the use of resources in the production process. It uses an average measure, e.g., output per worker or output per machine hour.

Reorder level refers to the level of stock when a new order is placed. Lead times mean that the reorder level helps to prevent production problems arising from a lack of stock.

Reorder quantity refers to the amount of new stock ordered. This can be seen from a stock control chart by calculating the difference between the maximum and minimum stock levels.

Stock control charts are visual tools used to graphically illustrate a simplistic system of stock control in a business.

A **stock-out** occurs if a business does not hold enough stocks to meet orders for production.

Stockpiling occurs when a business over-produces so holds too much stock, so is detrimental to the firm's cash flow position.

Stocks (or **inventories)** are the materials, components and products used in the production process, i.e., raw materials, semi-finished goods and finished goods.

The **supply chain** refers to the different stages of activities from the production of a good or service to it being distributed to the end customer.

Supply chain management (SCM) is the art of managing and controlling these activities, which must be efficient and cost effective for a business to be profitable.

The **usage rate** refers to the speed at which stocks are depleted. The higher the usage rate, the more frequent reordering of stocks needs to be.

Chapter 41

Unit 5.7 - Crisis management and contingency planning (HL only)

"The pessimist sees the difficulty in every opportunity. An optimist sees the opportunity in every difficulty."
- Sir Winston Churchill, Prime Minister of the UK (1940 - 1945 and 1951 - 1955)

Contents

5.7 Crisis management and contingency planning (HL only)	
HL content	**Depth of teaching**
The difference between crisis management and contingency planning	AO2
The factors that affect effective crisis management: • Transparency • Communication • Speed • Control	AO2
The impact of contingency planning for a given organization or situation in terms of: • Cost • Time • Risks • Safety	AO3

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Crisis management and contingency planning

The difference between crisis management and contingency planning. AO2

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A **crisis** is a situation of disequilibrium or instability that results in major problems for a business. Crises are usually unexpected and often unpredictable. In the event of an actual crisis, it is probable that costs to the business will be significant in terms of both time and money. At its extreme, a crisis can threaten the survival of an organization. All businesses, irrespective of their size, face the risk of experiencing a crisis (see Box 41.1). Hence, senior managers devise plans to minimize the damage that crises can cause to their organizations.



Figure 41.1 - Crises can take many forms

Box 41.1 shows some examples of real crises in the business world. Broader examples of crises include:

- Accidents such as fire damage to stock (inventory) and property
- Computer hardware failure
- Data loss or data breach caused by computer hackers
- Delayed flights due to adverse weather conditions or computer failure at airports
- Disruptions from terrorist attacks
- Insufficient cash flow to pay workers and suppliers (see Chapter 20)
- Loss or long-term sickness of key personnel
- Natural disasters such as floods, storms or earthquakes
- Negative and damaging media publicity, e.g., food poisoning at a restaurant
- No power due to a blackout or power cut
- Outbreaks of infectious diseases
- Surging levels of staff turnover
- Theft and vandalism.

Box 41.1 - Corporate crises

- 1985 - Coca-Cola, partly in response to the infamous *Pepsi Challenge*, launched a replacement product for regular Coke called *New Coke*. With 40,000 written complaints each day about the new product, Coca-Cola was forced to bring back its original-flavoured drink.
- 2004 - Coca-Cola introduced its bottled 'natural still water' called Dasani in England. It was later discovered that the water came from a tap and contained prohibited levels of bromate (a chemical compound that can cause cancer).
- 2006 - Sony recalled almost six million lithium-ion laptop batteries, costing the company around 20% of its net profits for that year.
- 2006 - Cadbury's suffered a £30 million ($44m) loss when a burst pipe in its Birmingham factory in the UK caused salmonella contamination to one million bars of chocolate.
- 2009 - UK retailers faced calamities during December when severe snowstorms prevented Christmas shoppers from going home. Customers stranded in John Lewis (a department store) and IKEA were allowed to use the in-store beds.
- 2011 - A 9.0 magnitude earthquake and tsunami caused major damage to Japan - the worst natural disaster in its recorded history which cost the economy 25 trillion yen ($309bn) and would take up to five years to sort out.
- 2013 - Typhoon Haiyan, the deadliest tropical cyclone ever to hit the Philippines, caused over 6,200 deaths and over $1.5 billion of damage.
- 2016 - Political and social turmoil ensued in Turkey, caused by military attempts to seize control of several key places including Ankara and Istanbul.
- 2018 - VISA faced huge problems when hardware failure prevented customers throughout Europe from using their credit cards to make payments at retail outlets.
- 2019 and beyond - The prolonged COVID-19 pandemic caused havoc to every industry in every country throughout the world.

5.7 Crisis management and contingency planning (HL only)

Crisis management refers to the response of an organization to a crisis situation. It is about being *reactive* to events that can cause serious problems to a business. The first decade of the 21st century saw events such as the terrorist attacks of 9-11 in the USA, the deadly SARS outbreak and a massive tsunami in Southeast Asia, world oil prices hitting historical highs and global pandemics of avian flu and swine flu. The COVID-19 pandemic has been the biggest crisis in living memory. Crises can also be unique to a business, such as a fire in the building or a sudden announcement of a hostile takeover from a competitor in the industry.

Unquantifiable risks (or **uninsurable risks**) are threats to a business that are impossible or prohibitively expensive to examine and measure. Most businesses find it extremely difficult (and unnecessarily expensive) to plan for such unpredictable and unquantifiable risks, which can have profound impacts on their operations. Hence, crisis management involves formulating the best response to a crisis. If a business finds itself faced with an emergency, then crisis management is required to minimize the impact on the business. Radical measures, centralized decision making and an autocratic style of leadership are likely to prevail.

Successful managers have the ability to respond to significant disruptions to their business by implementing a contingency plan to restore business operations in a timely manner. Hence, crisis management is sometimes referred to as disaster recovery. Effective crisis management requires the crisis management team to deal with crises in a swift way before they escalate into a terminal problem for the organization.



Figure 41.2 - The COVID-19 pandemic caused havoc in schools across the world

Case study 41.1

In 2010, BP was far too complacent with its safety checks, which led to an oil rig exploding in the Gulf of Mexico. The fatal blast at Deepwater Horizon took the lives of 11 workers and caused 4.9 million barrels of oil to spill into the ocean. The company's lack of a contingency plan and its slow response to the crisis resulted in the company being fined a record $20.8bn by the authorities. The overall cost of the oil spill to BP was over $62bn. The Deepwater Horizon disaster was so colossal that Hollywood made a movie about it in 2016.

Question 41.1 - Meat products recalled in the USA

In December 2021, Alexander & Hornung, an American meat company, recalled 234,391 pounds (106,318 kilos) of cooked ham and pepperoni products that may have been contaminated with Listeria monocytogenes, disease-causing bacteria. The meat products were shipped all over the nation to retailers like Walmart.

The US Department of Agriculture's Food Safety raised concerns that eating food contaminated with Listeria monocytogenes can cause listeriosis which can sometimes be fatal. The most vulnerable groups of customers include senior citizens, those with weakened immune systems, pregnant women and young children.

European supermarkets and retailers were hit by a similar crisis just a couple of months before when food products were recalled because of undeclared allergens and traces of plastics were found in some meat products.

(a) Describe, in the context of the case study, the meaning of a crisis. *[2 marks]*

(b) Examine how crisis management can help retailers such as Walmart to deal with such a crisis. *[6 marks]*

Contingency planning is about being *proactive* to changes in the business environment. It involves developing a plan before an unwanted, unpredictable or unlikely event occurs, by using 'what if?' questions to identify probable threats. Managers examine what might happen, estimate the likelihood of these events happening and assess the probable impacts on the business, e.g., a downturn in the economy, the loss of electricity and power, extreme weather conditions or strike action by the workforce.

Contingency planning helps with crisis management by preparing for a crisis or emergency. Anyone working in the insurance industry will testify that the future is difficult to quantify or predict; things are likely to turn out differently from what may have been planned. However, to reduce the risks and impacts of encountering a crisis, businesses need to carry out effective contingency planning. Essentially, this helps managers to be better prepared if there is an emergency, in order to ensure the continuity of the business.

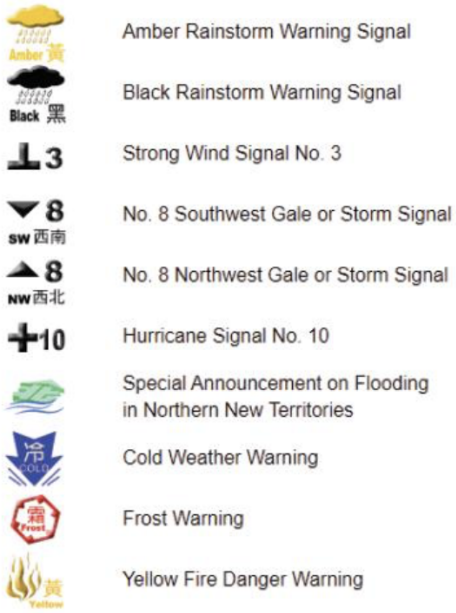

Figure 41.3 - Some of Hong Kong's weather warnings

At the most basic level, most organizations will have a contingency plan for the possibility of a fire in the workplace. The plan includes procedures for evacuation of the premises (including the use of emergency exits) and contacting the emergency services (fire, police and ambulance). It also includes details of the roles and responsibilities of members of the crisis management team. The crisis plan needs to be tested and reviewed. For example, fire drills are rehearsed to test the contingency plan. This might include actions such as response rates (to assess how efficiently people evacuate the buildings) and other tests performed under safe conditions. After the review is conducted, a report is submitted to the crisis management team, with recommendations for further improvements to the contingency plan.

Quantifiable risks (or **insurable risks**) are probable and financially measurable threats to a business, such as fire damage. The more quantifiable the crisis, the more effective a contingency plan tends to be. For example, the Philippines government has contingency plans for the onslaught of tropical typhoons and torrential rain. In Hong Kong and Macau, warning signals for typhoons and/or torrential rain are broadcast on the radio, Internet and television to inform and warn people accordingly. In extreme cases, such as a 'Hurricane signal number 10' or a 'black rainstorm' warning, businesses and schools are closed, as the severe weather conditions threaten people's safety. In Dubai and Qatar, severe heat warnings are signalled by governments. Schools and businesses are closed if the heat proves too dangerous for people to be outside for extended periods of time.

Hence, effective contingency plans enable a business to be better prepared to manage a crisis (by being proactive), rather than being totally unprepared to cope with the crisis should it occur (by being passive or reactive). Disaster recovery is far easier to execute if all risks and scenarios are clearly identified and quantified.

However, some risks are uninsurable as they are so difficult to quantify. This makes contingency planning challenging and less meaningful. Nevertheless, careful and effective planning can help an organization to become better prepared and resilient to any major catastrophes. Although some people argue that the plans may be unnecessary, given the low probability or unquantifiable nature of crises, most experts believe that businesses will become extremely exposed to the dangers of crises if they have no plan at all to follow. Of course, contingency planning does not eliminate all eventualities of a problem occurring. Nevertheless, careful planning can mean that the number and extent of shocks and surprises are reduced. As US Founding Father Benjamin Franklin (1706 - 1790) said, "*By failing to prepare you are preparing to fail.*"

Common mistake

Students often confuse crisis management and contingency planning, using the terms interchangeably. **Crisis management** (or disaster recovery) occurs *during* and *after* an event (such as the outbreak of a fire) whilst **contingency planning** happens before (planning a fire drill). The latter asks 'what if?' questions, such as what the firm should do if exchange rates or interest rates continually rise. By contrast, crisis management asks, 'what now?' questions.

ATL Activity 41.1 (Research skills)

Investigate a case where a celebrity endorsed by a company or brand has severely tarnished its image by his/her inappropriate behaviour. Discuss how far it is possible to plan for such a crisis

Question 41.2 - Bausch & Lomb



In April 2006, American eye care company Bausch & Lomb (B&L) had $500 million wiped off its stock market value following findings that the company's top-selling 'ReNu' contact lens solutions were linked to an unusual eye infection. Shipments of the contact lens solution from its South Carolina factory were halted by the US Centre for Disease Control and Prevention.

In 2021, Bausch & Lomb faced a similar problem in Europe, the Middle East and Africa, when the company conducted a voluntary product recall of certain B&L products that were manufactured at its facility in Milan, Italy. The move was a precautionary one as certain batches of B&L contact lens solutions, eye wash and eye lubricants were linked to causing some customers to suffer from discomfort and mild eye infections.

(a) In the context of the case study, describe what is meant by crisis planning. *[2 marks]*

(b) Discuss how far it is possible for a business such as Bausch & Lomb to plan for a crisis. *[10 marks]*

Exam tip ! Worked example

The managers at a production plant have estimated that, in the worst-case scenario, a crisis would cost the company $100 million. To what extent should the firm spend $500,000 today on crisis planning, knowing that crises might never happen? *[10 marks]*

Answer: Remember to start extended response questions like this with definitions - in this case, define the terms 'crisis' (a sudden and unexpected threat to the survival of the business) and crisis planning. Then present both sides of the argument:

Arguments for spending the $500,000 might include an explanation of the following points:

- Limits the damage caused in the event of an actual crisis occurring.
- The $500,000 is only 0.5% of the costs in the worst-case scenario, i.e., not spending this money can actually cost the company much more if there is an actual crisis (such as in the case of BP in Case study 41.1).
- It can give managers and workers at the production plant a sense of security (peace of mind).
- Arguments against spending the $500,000 include an explanation of the following points:
- Spending the money does not prevent a crisis from occurring.
- The $500,000 will diminish the firm's cash flow position today.
- The money might have been better spent on another project that would yield a financial return for the company and its shareholders.
- The likelihood of a real crisis occurring may be too low to justify the expenditure.

As the exam question requires you to address the 'extent' to which the spending is justified, a decision or judgment must be made. This will depend on several interrelated factors, such as:

- The probability of the crisis occurring.
- The nature and scale of the crisis.
- The nature of the business and its operations, e.g., the size of the firm and its financial position.
- The corporate culture and attitudes regarding risk taking.

Answers, as always, must be written in the context of the business and its organizational objectives.

Theory of Knowledge (TOK)

Does emotion or reasoning have the greatest impact in contingency planning?

Factors affecting effective crisis management

The following factors that affect effective crisis management: (i) Transparency, (ii) Communication, (iii) Speed and (iv) Control. AO2

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The effectiveness of crisis management is dependent on several factors, namely: (i) transparency, (ii) communication, (iii) speed and (iv) control in dealing with a crisis situation.

(i) Transparency

Transparency refers to being open and honest with all stakeholders during a crisis. It is about disclosing the truth, such as the scale or severity of the crisis. Most crisis management experts believe that it is best to be transparent (open and honest) during a time of crisis. Three examples from different decades are outlined below.

- In 1990, authorities in the USA found traces of benzene in Perrier bottled mineral water. Perrier, owned by Nestlé, tried to hide the truth from the general public, but this only served to damage its corporate image. The mass media saw Perrier putting profits before the interest of people and this led to the recall of 160 million bottles of its natural mineral water.

- Sanlu Group was given a bankruptcy order from the Chinese government in 2008 for its involvement and attempted cover up in an adulterated baby milk powder scandal. Sanlu Group was found guilty of contaminating its product with traces of melamine, which caused kidney stones and other complications in almost 300,000 infants.

- In 2015, the US Environmental Protection Agency (EPA) found that Volkswagen, Europe's largest carmaker, had deliberately programmed its diesel engines to cheat laboratory emissions tests, which were about 40 times higher than what is allowed in the USA. The scandal resulted in its share price plummeting and the CEO resigning. The German company had to spend $18.32bn to rectify the emissions issue and faced a criminal fine of $2.8bn in 2017.

The lesson to be learnt is that in times of such crises, acting in a socially irresponsible way with a lack of transparency is far more likely to cause long-term damage to the organization than if it had acted responsibly and taken the necessary corrective measures from the outset.

(ii) Communication

Communication refers to the transmission of information, by informing internal and external stakeholders to help them to know about and understand the issue. Effective communication with all key stakeholder groups is critical in a crisis situation, such as contacting the emergency services and insurers. Effective crisis management also requires leaders to develop a crisis communications plan, including an understanding of how the news media works. In the event of a crisis, leaders need to get a press release out immediately to contain the situation. They need to work with the media and attempt to get the press on their side.



Figure 41.4 - Effective communication is vital in a crisis situation

With the use of Internet technologies and social media platforms, it is relatively easy to communicate via the organization's website. This was the method used by Apple when announcing the death of Steve Jobs in 2011, the company's CEO at the time. Effective communications help to reassure employees, customers, suppliers, shareholders, investors and other stakeholder groups.

Common mistake

Too often, students write about major crises, assuming that crises have to occur on a national or international scale. However, crises can occur on a small scale, affecting a single organization. Examples include an unexpected power cut, machinery breakdown or the sudden illness of the CEO or owner of the business.

(iii) Speed

Speed refers to making prompt decisions and taking swift actions in order to return the business to normal operations as soon as possible. In a crisis situation, the speed of response is critical to the effectiveness of crisis management. This is comparable to a person who has had a major accident and needs immediate medical attention; if the critically injured person is treated straight away, the chances of survival increase significantly. The same principle applies to corporate crisis management situations. The speed of response to the crisis influences the chances of containing or reducing the damages caused. This is far more likely to happen if managers have an effective contingency plan and can act swiftly in emergency situations.

In 2022, Northern Powergrid, a British energy company owned by Berkshire Hathaway Energy, made a huge clerical error by sending out 74 cheques each for the sum of around £2.3 trillion ($3.26 trillion) to compensate customers affected by up to 13 days of power outages in November 2021. The company had noticed the error in time to prevent any cheques from being cashed and quickly communicated the error to its key stakeholder groups, with a fitting apology.

(iv) Control

Control refers to the use of a crisis management (or critical incident) team to handle an emergency situation and to ensure there is leadership and governance. A major crisis truly tests the performance and competence of the leadership team within an organization. Leaders need to be able to control the crisis situation. This entails many skills, including the ability to work under extreme pressures, to communicate with all key stakeholders (including the ability to manage the news media) and to make quick and effective decisions. A crisis will require leaders to have instant access to cash funds to control the situation and to continue business as usual (or as much as possible). Hence, many businesses will allocate finance to

a contingency fund when setting their annual budgets (see Chapter 22).

The Fukushima nuclear power plant disaster in 2011 was caused by the tsunami that followed the Tōhoku earthquake. The nuclear disaster caused substantial amounts of radioactive materials to be released. It was the largest nuclear incident since the Chernobyl disaster in 1986. Following a formal investigation into the accident, investigators blamed the catastrophe on a culture of complacency around nuclear safety and control as well as poor crisis management.

The impact of contingency planning

The impact of contingency planning for a given organization or situation in terms of: (i) cost, (ii) time, (iii) risks and (iv) safety. AO3

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The impacts of contingency planning, be they advantages or disadvantages, for a given business organization or situation can be examined in terms of several factor, namely: (i) cost, (ii) time, (iii) risks and (iv) safety. Ultimately, the advantages of contingency planning enhance the chances of the organization's survival during a time of crisis. However, the limitations or disadvantage also need to be considered in order to determine the impact of contingency planning on an organization.

(i) Cost

The public can be quite forgiving, especially if crises are beyond the control of a business. By contrast, untruthful and deceitful cover-up stories are frowned upon by the public and the mass media. Acting in a socially responsible way (see Chapter 3) can be a source of competitive advantage. Contingency plans can therefore help to minimize negative reactions and hence the costs (financial losses) of crises should they ever occur.

However, crises may never happen, so the time and money invested in contingency planning could have been better used elsewhere. Besides, no amount of planning can prevent the totally unexpected, such as natural disasters. Hence, over planning and over budgeting for crises can be inefficient use of a firm's scarce resources.

(ii) Time

Planning takes time but can save time in the event of a crisis. Would you know exactly what to do if you were at school and an uncontrollable fire breaks out? What about in the event of a lockdown if an intruder were to attack the school? Prompt action is imperative to minimizing the impact of crises and the disaster recovery process. Delays in responding to a crisis can allow problems to escalate beyond repair.

However, contingency planning uses up valuable management time and resources, thereby preventing senior managers to focus on other strategic priorities. It is also impossible to consider all scenarios; the more 'what if' situations that are considered, the more time that is spent on devising contingency plans. Time and resources are also needed to monitor, review and update these plans, including funds and time devoted to staff training to deal with potential crises.

(iii) Risks

Advocates of contingency planning argue that it helps to reduce risks as most potential threats or eventualities can be accounted for. A well-thought-out plan that can be easily followed in the event of a disaster helps to reduce overall risks. In the event of a catastrophic loss (such as injury or death), then the directors, managers or employees may be held personally or severally liable if company policies and guidelines were not followed, including possible non-compliance of health and safety legislation.

However, if plans are based on outdated information or inaccurate data, then inappropriate actions may be taken if a crisis occurs. Contingency plans, no matter how detailed and well thought out, do not guarantee the survival of the business or the safety of its people. There is also the risk that people outside of the contingency planning team do not take things so seriously (perhaps due to ignorance), which severely limits the advantages of producing these plans.

(iv) Safety

Immediate actions, such as communications with the organization's personnel, can help to alleviate or minimize the concerns of staff and meet their security needs (see Chapter 10). For example, most schools produce risk assessments for educational field trips, sporting activities and other outdoor pursuits. As part of a contingency plan, the risk assessments are produced to keep students and teachers as safe as possible, helping staff to know what to do in the event of an emergency. Contingency plans help in the process of effective handling

of staff concerns and anxieties, which is vital for the disaster recovery process.

However, in some cases, health and safety regulations and procedures can be overly complex and bureaucratic. For example, instructions for emergency evacuation of a building in the event of a fire may be disproportionately excessive, so such plans are inefficient and impractical in the event of a real crisis.

Theory of Knowledge (TOK)

Can anything good ever come out of a crisis that threatens the survival of a business?



Figure 41.5 - Health and safety are at the core of contingency planning

Question 41.3 - The COVID-19 pandemic



The COVID-19 pandemic has proved to be the greatest crisis in living memory, having caused havoc in industries in every country across the world. At the start of 2022, there were more than 412 million cases of people with the virus and more than 5.8 million recorded deaths globally.

Many businesses were forced into devising **contingency plans** to deal with the ongoing outbreak that caused many economies to go into lockdown. Schools across the world drew up plans to respond to the global pandemic that caused major disruptions to education and examinations. Many schools had to train their teachers to work from home, using remote learning technologies.

Whilst there are numerous factors affecting the effectiveness of how businesses and governments dealt with the coronavirus pandemic, effective **leadership** during any major crisis is vital in restoring confidence and getting society back to normality.

(a) Define the term *contingency plan*. *[2 marks]*

(b) Define the term *leadership*. *[2 marks]*

(c) Examine the costs and benefits to organizations such as schools of devising contingency plans. *[6 marks]*

Box 41.2 - Inventions, Crises and Wars

- Agricultural fertilizers
- Ballpoint pens
- Canned foods
- Daylight saving time
- Duct tape
- Jet engines
- Kleenex sanitary tissues
- Photocopying
- Plastic surgery
- Stainless steel
- Tea bags
- Vegetarian sausages
- Wristwatches
- Zips

ATL Activity 41.2 (Social and Research skills)

In groups of 3 or 4, investigate a recent corporate crisis in a country of your choice. How effective was the crisis management team in handling the crisis? Present your findings to the rest of the class.

Theory of Knowledge (TOK)

Which area of knowledge (AOK) do you think business leaders use most when deciding how to deal with crises? Justify your reasoning.

Key concept

For an organization of your choice, discuss the role of **change** and **ethics** in contingency planning and crisis management.

Question 41.4 - Toyota

Japanese car giant Toyota faced a huge crisis in 2018 when the company had to recall more than 2.4 million hybrid vehicles around the world due to a fault that could cause the cars to stall when in driving mode. The owners of the affected vehicles were notified by Toyota who stated the problem would be fixed by a software upgrade that would take around 40 minutes per vehicle. Toyota's head of global operations made a public appearance to apologize for the safety problems with its cars. A similar problem had occurred back in 2014 when Toyota recalled 2.1 million of its Prius, RAV4, Tacoma and Lexus models across Europe, North America and Japan. Again, this was due to a software problem that could cause the cars to stop suddenly.

Between 2009 and 2011, Toyota recalled a total of 9 million vehicles due to various mechanical problems. Analysts calculated the cost of the crisis for Toyota was $2.47 billion in the USA alone.

(a) Calculate the approximate number of hours it would have taken Toyota to fix the software problems for the cars recalled in 2018. *[2 marks]*

(b) Explain why product recalls can be damaging to a firm's corporate reputation. *[4 marks]*

(c) Evaluate whether it would be in Toyota's best interest to spend money on contingency planning or on improving the quality of its cars. *[10 marks]*

Crisis management, contingency planning and the key concepts

A crisis is a threat to the sustainability of any business. Crisis management is about dealing with the changes that these threats bring. Contingency plans can go some way to deal with crises. With any crisis, it is the planned prevention (contingency planning) and the proactive response of managers that minimize the impacts and changes caused by a crisis. To be of any use, the contingency plans must be properly and regularly tested, reviewed and updated based on any new information and changes in the internal and external environments. The crisis coordinator, usually a senior executive, works closely with a crisis management team and external agencies (such as lawyers, the press and the emergency services) to develop effective crisis management systems and processes.

Crises change the environment in which a business operates, so effective crisis management can be vital for its survival. Yet, it is questionable whether and how much time and resources should be devoted to planning for events that may never happen. Moreover, some risks are simply not quantifiable, so dedicating management time and resources to contingency planning may not be regarded as cost effective or efficient use of scarce funds. Even if a detailed plan does exist, given the unpredictable nature of crises, it is possible that businesses do not act according to plans once they actually face a real crisis.

Whatever the approach, it is important to act swiftly and transparently in an ethical way should a crisis occur. The mistakes of businesses such as Perrier and Bausch & Lomb have shown that immediate and transparent action can allow managers to take control of the situation in an ethical manner. *How* a business acts in a crisis can also raise ethical issues. For example, US regulators fined South Korea's Asiana Airlines $500,000 in 2014 for failing to help victims of a flight that crashed at San Francisco airport a year earlier. However, such responses require both careful contingency planning and an effective crisis management team to execute the plan. Only a properly trained representative should handle the media as the organization's official spokesperson. Any crisis could damage the corporate image of a business and reduce stakeholder confidence in the organization. Hence, contingency planning and crisis management often involve a strong focus on public relations (PR) aimed at establishing and protecting the desired corporate image.

Case study 41.2

You may be aware that adverse weather conditions can affect the actual IB examinations! Therefore, it is common for IB World Schools to have contingency plans in place. For example, severe snowstorms, hurricanes or flooding in the month of May in some countries mean that students are unable to travel to school to take their IB exams. Hence, schools need to include a detailed communications strategy to inform students and parents about procedures for rescheduling exams during adverse weather conditions, natural disasters and political turmoil. School leaders also need to liaise directly with the IB about procedures and processes for the postponement of any examinations.



Snowstorms can cause school closures

Although no two crises are exactly the same, there is much to be learnt from one situation which can help the firm to deal with future crises. Contingency planning takes time but can save managers a lot of time if a crisis does materialise. Crisis experts use their plans to create business opportunities out of a threat in order to operate in a sustainable way. John F. Kennedy (1917-1963), the 35th President of the USA, famously pointed out that the Chinese word for 'crisis' is composed of two characters - danger and opportunity. The Chinese characters for crisis are '危機', with the first character meaning danger or threat and the second character being part of the characters that make up the word opportunity or chance '機會'. Hence, out of every crisis, an opportunity arises to change for the better.

Nevertheless, effective crisis management allows the organization to deal with any uncertainties and the dynamics of change. Albert Einstein said that "*Intellectuals solve problems; geniuses prevent them.*" Effective managers must be both geniuses (by having contingency plans to prevent or minimize

the impact of crises) and intellectuals (by being able to execute effective crisis management).

Case study 41.3

During World War II, the Germans banned the import of Coca-Cola under a trade embargo. The head of Coca-Cola Deutschland (Germany) decided to produce an alternative drink called Fanta, using domestically sourced ingredients at the time. The name came from 'fantasie', the German word for 'imagination'. Ten years later, Coca-Cola launched Fanta across the world.

Business Management Toolkit

Discuss how organizational culture affects contingency planning and crisis management. You might find it useful to refer to Chapters 11 and 54 prior to answering this question.

REVIEW QUESTIONS

1. What is the meaning of a crisis?
2. What is crisis management and why is it of value to businesses?
3. What is contingency planning?
4. How does crisis management differ from contingency planning?
5. What are the advantages of contingency planning?
6. What are the disadvantages of contingency planning?
7. What are the main factors that affect the effectiveness of crisis management?
8. Why is it important to take immediate action when a crisis occurs?
9. Why is it important to be transparent about issues and concerns during a crisis?
10. Why do some people question the value of contingency planning?

KEY TERMS

Communication is one of the factors that affect the effectiveness of crisis management, by informing internal and external stakeholders to help them to know and understand the issue.

Contingency planning is about being proactive to changes in the business environment. It involves developing a plan before an unwanted, unpredictable or unlikely event occurs, by using 'what if?' questions to identify probable threats.

Control is one of the factors that affect the effectiveness of crisis management, by using a crisis management (or critical incident) team to handle a crisis and to ensure there is leadership and governance.

A **crisis** is a situation of disequilibrium or instability that results in major problems for a business, e.g., natural disasters, major accidents and computer equipment failure.

Crisis management refers to the response of an organization to a crisis situation. It is about being *reactive* to events that can cause serious problems to a business, i.e., taking appropriate action as and when a crisis occurs.

Quantifiable risks (or **insurable risks**) are probable and financially measurable threats to a business, such as fire damage.

Speed is one of the factors that affect the effectiveness of crisis management, by making prompt decisions and actions in order to return to normal operations as soon as possible.

Transparency is one of the factors that affect the effectiveness of crisis management, by being open and honest with all stakeholders during a crisis, i.e., disclosing the truth, such as the scale or severity of the crisis.

Unquantifiable risks (or **uninsurable risks**) are threats to a business that are impossible or prohibitively expensive to examine and measure.

Chapter 42
Unit 5.8 - Research and development (HL only)

"Anyone who has never made a mistake has never tried anything new."
- Albert Einstein (1879 - 1955), Nobel Prize Winner for Physics, 1922

Contents

5.8 Research and development (HL only)	
HL content	**Depth of teaching**
The importance of research and development for a business	AO3
The importance of developing goods and services that address customers' unmet needs (of which the customers may or may not be aware)	AO2
Intellectual property protection: copyrights, patents, trademarks	AO2
Innovation: incremental innovation and disruptive innovation	AO2

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Research and Development (R&D)

The importance of research and development for a business. AO3

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Research refers to investigating the unknown, such as new products or processes. It helps to improve our understanding about something in particular. Development involves using research findings to create products that can be commercialized. **Development** can also mean improving existing processes or products, i.e., improvements in process innovation and cost-reducing innovations.

Research and development (R&D) refers to the technological and scientific research that helps to generate a flow of new commercial ideas and processes. It involves activities undertaken to innovate and introduce new goods and services or to improve existing ones to meet the needs of customers, of which they may or may not be aware. The purpose of R&D is to provide continual advancement (e.g., modifications or improvements to existing products) and to launch new products to satisfy customer needs in a profitable way.

R&D often involves conducting extensive research into new products, their designs, testing and development of **prototypes** (trial or test products). Prototypes are designed, tested and developed with the hope of eventual commercial production. However, the R&D process can be extremely lengthy and drain the resources of a business. Furthermore, due to the high risks involved, only the most promising ones are considered for commercialization. For example, pharmaceutical companies often spend hundreds of millions of dollars each year on R&D, yet it can take more than a decade to commercialize a drug or medicine.

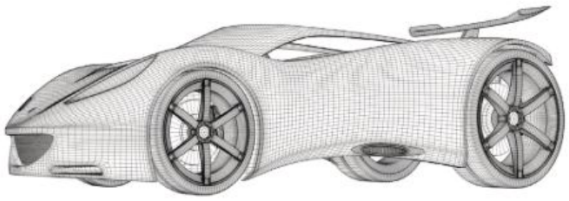

Figure 42.1 - Prototypes are used as part of the R&D process

R&D can be vital to an organization's long-term survival and success. Kodak, for instance, went bankrupt after falling behind the times as customers switched from using camera film (see Figure 42.3) to digital camera technology. R&D can also improve the efficiency and performance of an organization, thereby adding value in the production process. For example, Apple and Microsoft have thrived on R&D as a source of higher sales growth and increased market value. Japanese carmaker Honda allocates 5% of its annual budget for R&D.

R&D often pays off for businesses that operate in **sunrise industries** (those that have rapid growth potential, such as high-tech industries). In addition, R&D can generate a first-mover advantage, i.e., the benefits of being the first business to launch a new and innovative product, such as Tesla's electric car (2012), Apple's iPod (October 2001) or Pfizer's Viagra impotence drug (March 1998). Such benefits include the ability to charge a premium price, to develop a favourable corporate image and to establish strong market share. Hence, having a first-mover advantage better prepares a business to contend with the likely competition that follows. By contrast, R&D expenditure in **sunset industries** (where there is negative or deteriorating growth potential) is unlikely to be profitable.

Furthermore, studies have consistently shown that for every ten products that are developed and test-marketed, only one product reaches commercialization. Hence, the successful product that is launched must recoup the high costs of R&D, even if this takes several years.

R&D is a continual process. American inventor Thomas Edison (1847 - 1931) said, "*I have not failed. I've just found 10,000 ways that won't work.*" Firms that continue to invest in R&D, even if everyone else is cutting back, perhaps due to a recession, are the ones most likely to thrive in the future. Successful R&D can give businesses a competitive edge in terms of cost advantages and/or quality improvements in the long term.

Case study 42.1 - Tesla

Tesla is a US multinational company known for its well-designed and high-quality electric vehicles, although the business also specializes in lithium-ion battery energy storage and solar panel manufacturing. Founded in 2003, the first all-electric Model S car was sold in 2012. Sales of Tesla's electric cars passed the 300,000 vehicles milestone in early 2018. By June 2021, Tesla became the world's first electric carmaker to sell 1 million vehicles.

Box 42.1 - The importance of R&D

- *Growth opportunities* - R&D and product innovations can be important sources of business growth and evolution. Nintendo (games consoles) originally sold playing cards, whilst Nokia (mobile phones) started business in the pulp mill industry.
- *Productivity gains* - R&D and process innovations can help a business to increase its productivity and efficiency levels.
- *International competitiveness* - R&D can give a business or country a competitive edge over its foreign competitors.
- *Brand switching* - This occurs when consumers turn away from the products of a competitor, perhaps due to the firm providing a more appealing or innovative product through the R&D process. Firms continually try to get customers to switch to their brands and products.
- *Job creation* - R&D and product innovation can help to create plenty of employment opportunities in an industry.
- *Social benefits* - Innovation can often improve the quality of life for many people, e.g., developments in laser technology for correcting eyesight has meant that many people no longer need to rely on glasses or contact lenses.

Theory of Knowledge (TOK)

In 2020, the iPhone was voted by the British public as the World's Best Product. *The Economist* voted the modern flush toilet as the most useful invention in history. Other research suggests the printing press, lightbulb, wheel, automobile and compass as the most innovative products of all time.

How do people determine what is the 'best' product or innovation? How can we 'know' whether technology has truly improved our quality of life?

Despite the importance of R&D to businesses, there are several limitations:

- *High costs* - Investment in R&D can be highly expensive and requires sufficient labour and financial resources, as well as a lot of time.
- *High failure rate* - Most new ideas fail to materialise. Even for the few ideas that might work, most are not commercially feasible. Failure not only leads to a loss of investment funds but can also demoralise the workforce.
- *Budgetary constraints* - R&D is often held back by funding problems. Even if an innovative idea is realistically achievable, budget constraints can prevent the project from being undertaken.

Theory of Knowledge (TOK)

The 2008 global financial crisis caused hundreds of banks around the world to be bailed out (rescued) by governments. For example, the UK government spent over £139.5 billion ($203 billion) or about 20% of its GDP, saving commercial banks.

Should businesses, irrespective of their size, be allowed to fail?

R&D and customers' unmet needs

The importance of developing goods and services that address customers' unmet needs (of which the customers may or may not be aware). AO2

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R&D is a vital aspect in the process of commercially pioneering new ideas and creations to meet the unmet needs of customers. These unmet needs may be known to customers (perhaps from market research), whereas some of these unmet needs will be unknown to customers (due to radical or disruption innovations that create demand for new goods and services). For example, Apple's co-founder Steve Jobs famously said that he would create products that customers don't even know they need yet.

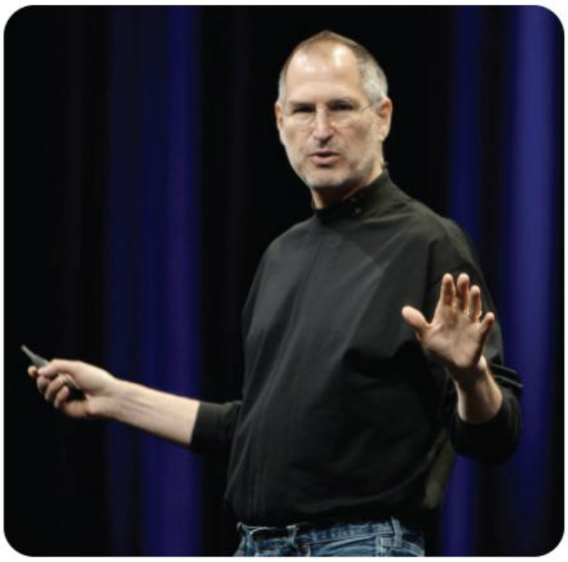

Figure 42.2 Steve Jobs, visionary innovator and co-founder of Apple Inc.

Other examples of the role of R&D in meeting the needs and expectations of customers include:

- *Discovery of new production processes* - Henry Ford, for example, discovered and applied the benefits of mass production and mechanisation to the automobile industry. Online banking in the early 21st Century transformed the finance industry. Marketing strategies have also evolved with developments in social media marketing and creativity in using through the line promotional strategies (see Chapter 29).
- *Successful exploitation of creative ideas* - Sir James Dyson is credited for inventing the bagless vacuum cleaner, helping to turn Dyson into a multi-billion-dollar business. Sabeer Bhatia, inventor of Hotmail, sold his email idea to Microsoft

for $400 million in 1997 (see Question 42.2). YouTube was sold to Google for $1.65bn in 2006, less than 2 years after it was set up by three ex-employees of PayPal.

- *Introduction of new products* - Coco Chanel popularised the 'little black dress' (simple but stylish black evening dress) in 1928 which is still as popular today. Apple's iPod revolutionised the way in which music is delivered to customers (the global decline in music CD sales was largely due to Apple's iTunes as customers switched to buying and streaming music online). Apple's multimedia iPhone also transformed the mobile phone market. Australia was the first country to issue polymer plastic bank notes, with more than 20 countries following its lead. The Bank of England used cotton paper notes for over 100 years but converted to polymer bank notes in 2016. Kodak was the market leader in the camera film industry for over 100 years but failed to keep pace with digital camera technologies.



Figure 42.3 - Kodak failed to keep up with customers' changing needs

- *Entering new markets* - Ferrari has long faced the dilemma of wanting to sell more cars without damaging its image of exclusivity. Founded in 1947, Ferrari did not expand into China until 45 years later, allowing the Italian supercar maker to exceed its quota of 5,000 cars produced each year since the Chinese market does not affect the elitism enjoyed by Ferrari customers in Europe and North America.

Management guru Peter Drucker said that all successful businesses at some point required a manager to make courageous decisions. He argued that businesses cannot grow through cost cutting alone but require R&D and innovation to sustain or increase their profitability. For instance, Apple's revolutionary iPod was introduced in October 2001 and in just 5 years had sold over 60 million units worldwide. By early 2007, Apple had sold its 100 millionth iPod, significantly boosting the company's earnings. Nevertheless, the iPod was discontinued in 2014 due to the shift in customer preference for online streaming music services. As Ken Loh, Regional Director of Kalmar (a multinational B2B manufacturer of heavy industry products and vehicles) said, "*The future success of a company is dependent on whether it will invest to meet customers' needs and expectations in order to increase competitiveness.*"

Question 42.1 - Nintendo Company

The Nintendo Company (Nintendo) is a Japanese multinational company that specialises in the games console market. Established in 1889, the company originally produced playing cards. Nintendo introduced its first video games in the late 1970s. Since then, games such as Donkey Kong and Mario Bros and products such as Game Boy, Super Nintendo, Nintendo GameCube and Nintendo Switch have made the company a household name throughout the world.

In March 2017, the company launched its seventh-generation games console, the Nintendo Switch, which used wireless and Bluetooth technologies. Nintendo allocated over $200 million for the launch to improve the chances of its success. This is important for the company's **brand loyalty**. Nintendo launched its latest-generation console, the Nintendo Switch OLED, in late 2021, which allows users to supplement the device with cloud gaming technologies.

(a) Define the term *brand loyalty*. *[2 marks]*

(b) Explain the importance of innovation for businesses operating in a rapidly changing market, such as the games console industry. *[4 marks]*

(c) Examine the factors that affect the degree of research and development (R&D) in a business such as Nintendo. *[6 marks]*

ATL Activity 42.1 (Research and Thinking skills)

In 2014, Mozilla launched a prototype $25 mobile phone aimed at customers in low-income countries. Investigate the motives behind this for Mozilla, which is more famous for its Firefox internet browser. How do such innovations address unmet customer needs yet disrupt the market? A good starting point is this BBC article: http://goo.gl/LNJQG8

Theory of Knowledge (TOK)

Do marketers make people happier? Is it possible to know whether marketers really care about our emotions and wellbeing?

Theory of Knowledge (TOK)

The *International Business Times* reported that a Ferrari 458 Italia is priced at about $230,000 in the US, but the same car is priced at $724,000 in China. What role, if any, do ethics have in commercialized innovations?

Theory of Knowledge (TOK)

Using two areas of knowledge, discuss why nations desire to innovate.

Intellectual property protection

Intellectual property protection: (i) copyrights, (ii) patents and (iii) trademarks. AO2

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Intellectual property rights (IPRs), also referred to as **intellectual property protection**, are the legal and exclusive ownership claims to certain creations, inventions or pieces of work. They act to prevent other parties from replicating the ideas of the inventor or creator. Hence, IPRs act as an incentive for businesses to innovate. Also, IPRs allow the owner to benefit from having a first-mover advantage as there is scope to take advantage of having a monopoly position in the market. The main types of IPR are (i) copyrights, (ii) patents and (iii) trademarks.

(i) Copyrights

Copyrights provide legal protection for artists and authors by preventing others from using or replicating their published works without permission. Governments grant the permission to hold copyrights for a finite period of time. Works that have been protected by copyright often carry the © symbol. Copyrights are popular in the music, film, drama, art, photography, software and publishing industries.

Authors such as J.K. Rowling, Dan Brown and Stephen King have made their fortunes from selling their copyrighted works to large Hollywood movie studios. Rowling's highly successful *Harry Potter* books have earned her international fame and ensured she became the first person to earn over $1 billion from writing.

Note: This textbook, whilst not in the same league as the authors above, is protected by international copyrights. Reproduction and redistribution in physical or electric format are strictly prohibited, irrespective of whether or not this is for financial gain.

(ii) Patents

A **patent** is the legal right to be the exclusive producer or user of a newly invented process or product, for a finite period of time. Patents existed as far back as 1449, when a patent was granted in the UK for the process of making stained glass windows. A patent is granted after the inventor has registered and satisfied the conditions stipulated by the government. Not all applications for a patent are approved, especially if the ideas are not new or are simply minor improvements to existing technologies or processes.

Patents can be held by individuals or businesses as intangible assets (see Chapter 17). They do not come free of charge, so patents applications are only submitted for inventions that are likely to be commercially profitable over a long period of time. Ownership of the patent can then act as a barrier to entry as the patent prevents competitors from using the invention (without the prior consent of the patent holder). The patent holder is also entitled to sell the technology or invention to another business.

A famous example of a patent holder is Dyson Limited. James Dyson pioneered the bag-free vacuum cleaner in 1978 and patented the technology five years later through licensing his invention in Japan. The invention made Dyson one of Britain's best known and wealthiest people. Dyson now sells highly innovative products throughout the world and has annual sales of over $8.2 billion.

Another famous example of a patent is the Tetra Pak used for packaging drinks such as milk and fruit juice. Swedish inventor and company founder Ruben Rausing came up with the tetrahedral container idea in 1943 and successfully patented it the following year. Today, Tetra Pak is the world's largest supplier of drinks cartons.



Figure 42.4 - The Tetra Pak is used throughout the world for packaging drinks

The main drawback of using patents is that the whole process is time consuming and bureaucratic. For example, it can take several years from applying for a patent to having it being granted. Also, most applications are rejected. Back in 2006, Microsoft applied for almost 3,500 patents and less than half of these were approved. In 2021, IBM had 8,682 registered patents, which was significantly more than any other company in the world (Samsung had the second most with 6,366 patents and Canon was third with 3,021 registered patents). Businesses that are granted a patent will have to pay for their renewal, often on an annual basis. Nevertheless, the advantages of owning a patent can be quite significant (see Box 42.1).

Charles H. Duell, Commissioner of the US Office of Patents in 1899, claimed that "*Everything that can be invented has been invented.*" How wrong he was! Without patents, there would be minimal incentive for innovation because competitors could simply copy the invention without the initial R&D costs. Alternatively, a business might buy a patent from the inventor. This can be cost effective compared to spending an uncertain amount of money on R&D with no reassurances of commercial success. This is especially true for patents that are nearing their expiry date, so the value or cost of the patent is lower.

(iii) Trademarks

A **trademark** is a sign, slogan or logo that represents a business or a product belonging to that business. If the trademark is registered at a patent office, it acts as a barrier to rivals wanting to imitate the product name or symbol. Trademarks that have been registered can, but do not necessarily, carry the ® symbol next to the mark. However, it is illegal to use this symbol if a trademark has not been registered.

Trademarks are often used as a form of branding (see Chapter 27). For example, *suggestive trademarks* are used to give customers a hint about the nature or characteristic of a product, e.g., BMW's Mini (small). A *descriptive trademark* is used to show a direct link between the brand and the product, e.g., *Pictionary* and *Monopoly* board games. Finally, *arbitrary trademarks* are purely random and meaningless names, e.g., Apple computers or Häagen-Dazs ice cream.

Case Study 42.2 - Best-selling Christmas song of all time

In 1973, Slade recorded *Merry Christmas Everybody*. Over 45 years on, the song remains top of the charts for royalty-earning Christmas songs, with the band receiving an impressive $1.28 million each year!

Question 42.2 - BMW and Rolls-Royce

In 1998, BMW paid $65m for the *Rolls-Royce* logo and brand name, which it has been able to use since 2003. This was considered as a major bargain by most analysts, given the high status and reputation of the trademark. To put this into context, the Volkswagen Group paid over $625 million in the same year to purchase Bentley Motors Limited.

BMW's acquisition of the Rolls-Royce trademark also enabled BMW to take control of Rolls-Royce Motor Cars Ltd., makers of luxury automobiles.

(a) Define the term *trademark*. *[2 marks]*

(b) Examine the role *and* importance of intellectual property rights for BMW. *[6 marks]*

Case Study 42.3 - Meta

In December 2021, Meta (the owner of social media network Facebook) paid $60 million in a deal to acquire the trademarked name of US bank Meta Financial Group based in South Dakota. The deal to secure the name rights occurred after Facebook's parent company had changed its name to Meta Platforms in October 2021.

Innovation

Innovation: (i) incremental innovation and (ii) disruptive innovation. AO2

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Innovation is the process of commercially pioneering new ideas and creations in the production process. It stems from successful R&D in order to meet the needs of customers in a profitable way. Examples of innovations and inventions are shown in Box 42.2.

Box 42.2 - Famous inventors and inventions

Although there are technical differences between innovation and inventions, the terms are often used interchangeably. Examples of famous inventors and their inventions include:

- **Levi Strauss** and business partner Jacob Davis (1873) secured a patent for trousers strengthened with metal rivets to make work wear more durable, later modifying this for their world-famous blue denim jeans.
- **Coca-Cola** (1886) was invented by John Pemberton, an American pharmacist. He sold the product as a remedy for depression, hysteria and anxiety.
- **Band-Aid** (1920), the adhesive bandage, was invented by Johnson & Johnson employee Earle Dickson. Dickson went on to become Vice President of the company.
- **Laszlo Biro** (1938) was a Hungarian journalist who invented the famous ballpoint pen.

Box 42.2 - Famous inventors and inventions cont...

- **Bubble Wrap** (1957) was invented by Alfred Fielding and Marc Chavasnnes, founders of the Sealed Air Corporation. *Bubble Wrap* is a registered trademark of the American packaging materials company.
- **Roy Jacuzzi** (1968) invented the first autonomous bath with fitted water jets.
- **Post-it notes** (1968) were accidentally invented by Arthur Fry and Dr. Spencer Silver, employees of 3M. The company's slogan is a single word - "Innovation".
- **Microsoft** (1983) announced the introduction of its new operating system - 'Windows' (although it was originally called Interface Manager). Today, it is the world's most widely used operating system, with more than 70% market share.
- **Facebook** (2004) is the world's largest social networking website. It took under 9 years for the company to reach 1 billion registered users. The phenomenon made co-founder Mark Zukerberg the world's youngest billionaire, aged just 26 at the time.
- **WhatsApp** (2009) is the world's most used instant messaging service with more than 2 billion users worldwide by 2022. It had over 450 million registered users within its first 5 years. WhatsApp was bought by Facebook in 2014 for $19.3 billion.

Innovation can be categorised as incremental or disruptive.

(i) Incremental innovation

Incremental innovation refers to minor improvements to products, services or work processes. For example, car manufacturers might work on developing safer and more energy efficient vehicles. Gillette, the world's largest producer of shaving supplies, regularly upgrades its razors, adding new features such as extra blades and pivoting functions. The majority of innovations are incremental in nature as they are more affordable, of lower risk and less disruptive to organizations.

(ii) Disruptive innovation

Disruptive innovation refers to any major innovation that introduces a new good or service designed to replace an existing one by radically altering the market. Such innovations can possibly displace established market leaders and their products. For example, vinyl and cassette tapes were replaced by CD technology (which has succumbed to the growing use of Internet downloads); VHS videos were replaced by DVD technology; and digital photography replaced film photography. It tends to involve high risks but can be a major source of competitive advantage and can be an important element of a firm's long term survival strategy.



Figure 42.5 - VHS videos were replaced by DVD technology

Question 42.3 - Johnson & Johnson

Johnson & Johnson is one of the world's largest health care and pharmaceutical companies. Founded in 1886, the company sells its products in over 175 countries, with annual sales revenues in excess of $82.6 billion. Its brands include Johnson's Baby products, Acuvue contact lenses, Neutrogena skin and beauty products and Band-Aid bandages. Its subsidiary, Johnson & Johnson Pharmaceutical Research and Development (J&JPRD), is responsible for discovering and developing pharmaceutical drugs, with research facilities in the USA, Belgium and Spain. Johnson & Johnson's website has a section dedicated to **innovation**, which invites the general public to submit their ideas for the company's consideration.

Source: adapted from https://www.jnj.com/about-jnj

(a) Define the term *innovation*. *[2 marks]*

(b) Explain the importance of research and development (R&D) to Johnson & Johnson. *[4 marks]*

(c) Given that most new products fail to reach the market, discuss the extent to which R&D expenditure can be justified. *[10 marks]*

Question 42.4 - Hotmail

Hotmail, the free email service, was started in 1996 by Sabeer Bhatia and Jack Smith, both ex-employees of Apple. Their vision was to give people access to email from any computer in the world. Bhatia and Smith had attracted their one millionth subscriber within the first six months of Hotmail's launch. By its 18th month, on Bhatia's 29th birthday, Hotmail had been bought by Microsoft for $400 million.

Hotmail has moved on since its early days. For example, MSN Messenger was launched in 1999 and allowed Hotmail subscribers to use instant messaging services. Webcam technology also allowed MSN Messenger customers to use audio and visual features. This has since been replaced by the upgraded Windows Live Messenger. In 2012, Hotmail was revamped and rebranded as Windows Outlook.

(a) Explain why Hotmail was seen as an innovative product. *[4 marks]*

(b) Examine the importance of innovation to high-tech businesses such as Microsoft. *[6 marks]*

Theory of Knowledge (TOK)

To what extent is research and development (R&D) limited by ethical considerations?

Research & Development and the key concepts

The pace of change in certain industries means that effective R&D expenditure is increasingly important. When cameras were first invented, there was very limited competition, so manufacturers enjoyed stability in the industry. Over time, with the invention of 35mm camera film, the market became dominated by market leaders such as Kodak, Minolta and Fuji. Competition led to continuous improvements that fuelled R&D. However, with the introduction of digital cameras and then mobile devices with digital camera functions, competition has intensified to a global level with R&D focusing on continuous innovations.

Stability becomes less certain in an ever-changing business world. R&D can certainly be the catalyst for change. For example, the first edition of the Encyclopaedia Britannica was printed in Edinburgh, Scotland but it finally went out of print in 2012 after 244 years. This was the harsh reality of the digital age, including competition from open sources like Wikipedia. Although Faber-Castell has over 260 years of history in producing pens and pencils, is it simply a matter of time before we no longer need to use pens and pencils? The IB will eventually replace paper-based exams with online assessments. Hence, the ability to adapt to and manage changes in the business environment will enable organizations to achieve better customer satisfaction and hence to sustain or improve their profitability.



Figure 42.6 - How long will it be before these products become innovations of yesteryear?

In rapidly changing markets, such as the movie industry or the computer games market, R&D and innovation are key factors to business longevity and financial success. Product life cycles (see Chapter 27) in these markets are very short and consumer demand is continually changing (demanding 'better' and more exciting films and computer games, for example). In addition, production costs tend to be very high, thereby making the risk of failure a real threat. Therefore, innovation is paramount in these industries. Seeking new market opportunities is a crucial source of innovation, e.g., downloading television programmes, movies and computer games onto smartphones and portable media players.

Essentially, businesses that are able to embrace change are more likely to survive and thrive, especially in industries where the life cycle of many products is short. Hence, any effective and creative business strategy is likely to include R&D expenditure to ensure the organization copes with changes and disruptions in the external environment.

Business Management Toolkit

To what extent does corporate culture impact R&D? You may want to refer to Chapters 11 and 54 before addressing this question.

Ethical considerations may also influence R&D practices and strategies. Most governments encourage R&D and innovation through the protection of intellectual property rights (IPRs). Not only is it unethical to infringe the IPRs of others, but it is also illegal. However, IPRs have become of greater concern to many businesses due to developments in Internet and online technologies. Some countries do not have laws governing the use of IPR on the Internet, for example. The common practice of music and video downloads, for instance, is still very challenging for governments to enforce. The United Nation's World Intellectual Property Organization (WIPO) has gone some way to encourage and promote the protection of IPRs around the world. However, the existence of non-complying and non-participating countries presents somewhat of a challenge for multinational companies and the WIPO. This can threaten the sustainability of some businesses so often deters R&D expenditure.

There are also huge ethical issues and implications of how R&D is conducted. For example, cosmetic companies might test their products on animals or dispose of their wastes in unenvironmentally friendly ways. Similarly, R&D can impact on the ethical practices of organizations. For example, many

schools around the world have used professional research findings to promote healthy eating, so have banned junk foods and high-caffeine and sugary drinks such as coffee, Coca-Cola, Red Bull and Lucozade.

Ultimately, R&D can help to address the unmet needs of customers. It is at the heart of problem-solving and is a major force of change. Billionaire Stelios Haji-loannou (b.1967), founder of the easyGroup, made his fortunes by being highly innovative. He suggested that entrepreneurs ought to be pioneers not copiers of the ideas of others, so that customers choose their products over those of their competitors. Some industries, such as pharmaceuticals and consumer electronics, rely more on R&D than others. Nevertheless, R&D and innovation can give any business a major and long-lasting competitive advantage.



Figure 42.7 - easyJet was the first company owned by easyGroup and remains one of Europe's largest low-cost airlines

Nevertheless, the cost implications and the high product failure rates often prove too large a barrier. R&D expenditure cannot and does not guarantee success. As Coco Chanel said, "*One cannot be forever innovating. I want to create classics.*" On the other hand, 'classics' can only be achieved if businesses are prepared to take the necessary risks. After all, it is not possible for businesses to grow without taking some calculated risks in an ever-changing world. As Charles Darwin (1809-1882) said "*It is not the strongest of the species that survive, not the most intelligent, but the one most responsive to change.*" The challenge for managers is to strike the right balance.

Theory of Knowledge (TOK)

To what extent does R&D (research and development) determine the wealth of a country?

Key concept

With reference to an organization of your choice, discuss how **change** and **ethics** have affected research and development (R&D) practices.

Key concept

For an organization of your choice, discuss the role of **creativity** in research and development (R&D).

Business Management Toolkit

Why is the protection of intellectual property rights for a successful differentiation strategy (one of Porter's generic strategies, as explained in Chapter 53)?

Business Management Toolkit

Discuss how circular business models (see Chapter 51) can lead to greater resource efficiency in organizations.

REVIEW QUESTIONS

1. How does research differ from development?
2. What is meant by research and development (R&D)?
3. What are prototypes?
4. How might R&D help a business to gain a first mover advantage?
5. How do sunset industries differ from sunrise industries?
6. What is meant by intellectual property protection?
7. What are copyrights?
8. What are patents?
9. What are trademarks?
10. How does incremental innovation differ from disruptive innovation?

KEY TERMS

Copyrights provide legal protection for artists and authors by preventing others from using or replicating their published works without permissions.
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Disruptive innovation refers to any major innovation that introduces a new good or service designed to replace an existing one by radically altering the market.

Development is the use of research findings to create products that might be commercialized. It can also mean improving existing processes or products.

Incremental innovation refers to minor improvements to products, services or work processes.

Innovation is the process of commercially pioneering new ideas and creations in the production process.

Intellectual property rights (or **intellectual property protection**) are the legal and exclusive ownership claims to certain creations, inventions or pieces of work. They consist of copyrights, patents and trademarks.



Figure 42.8 - Piracy is an infringement of intellectual property rights

A **patent** is the legal right to be the exclusive producer or user of a newly invented process or product, for a finite period of time.

Prototypes are trial or test products used in the R&D process. Prototypes are designed, tested and developed with the hope of eventual commercial production.

Research refers to the commercial investigation of the unknown, such as new products or processes.

Research and development (R&D) is the technological and scientific research that helps to generate a flow of new commercial ideas and processes, e.g., modifications or improvements to existing products and launching new products.

A **sunrise industry** is a growing industry that has significant growth potential, which helps to justify R&D expenditure.

A **sunset industry** is a declining industry where there is no or even negative growth in the market. This makes R&D expenditure difficult to justify, so it is often withdrawn.

A **trademark** is a sign, slogan or logo that represents a business or a product belonging to that business.

Chapter 43
Unit 5.9 - Management Information systems (HL only)

"Data is like garbage. You'd better know what you are going to do with it before you collect it."
- Mark Twain, (1835 - 1910), American writer and humourist

Contents

5.9 Management information systems (HL only)	
HL content	**Depth of teaching**
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Database	AO1
Cybersecurity and cybercrime	AO1
Critical infrastructures, including artificial neural networks, data centres and cloud computing	AO2
Virtual reality	AO2
The internet of things	AO2
Artificial intelligence	AO2
Big data	AO2
Customer loyalty programmes	AO3
The use of data to manage and monitor employees; digital Taylorism	AO3
The use of data mining to inform decision-making	AO3
The benefits, risks and ethical implications of advanced computer technologies (collectively referred to here as "Management Information Systems") and technological innovation on business decision-making and stakeholders	AO3

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Data analytics (AO1)

Data analytics is the process of transforming raw data into usable information for businesses. It is the art of examining raw data to draw conclusions about that information, such as determining trends and answering questions. Much of data analytics has been automated, including the use of computerised processes and algorithms.

Data analytics techniques can help to determine trends and other measures from a mass of data so that the information becomes more user friendly to improve the overall efficiency of a business. For example, data analytics is commonly used in the travel and hospitality industries to support business decision making, such as the setting of appropriate prices at different times of the year. In the retail industry, vast amounts of data are collected and analysed to help businesses meet the ever-changing demands of consumers.

Types of data analytics include:

- *Descriptive data analytics,* which describes and answers questions about what has happened over a period of time. It can help to keep track of business successes and failures as well as providing essential insights into past business performance. For example, data can be used to describe what has happened to a firm's sales revenues over a given period of time.

- *Diagnostic data analytics*, which focuses on and answers questions about why something has happened. It goes beyond finding out what has happened by determining the cause and examining why it has happened. For example, to determine the extent to which a promotional campaign or change in pricing method has impacted sales volume.

- *Predictive data analytics*, which projects and answers questions about what is likely to happen in the foreseeable future. For example, this approach enables managers to extrapolate data and make more realistic sales forecasts by using historical data to identify trends. Such techniques include the use of simple linear regression (see Chapter 58).

- *Prescriptive data analytics*, which supports strategic planning and an appropriate course of action by answering questions about what should be done. For example, if data analytics suggests a high likelihood of warmer summer evenings, restaurants may need to order more food and drinks, as well as hire more staff in anticipation of more diners.

Essentially, data analytics is important because it helps businesses to improve their efficiency, cut costs and gain competitive advantages in order to increase their profits. It enables businesses to gain insights that were not previously accessible in order to establish new patterns and correlations in large data sets. Data-driven decisions are more objective (as they are based on evidence) so help to reduce risks. Having large amounts of data and relevant information enables businesses to improve their performance, such as helping to identify consumer trends and raising customer satisfaction by providing new and better-quality goods and services. Ultimately, data analytics can be used to make more informed business decisions notwithstanding uncertainties in the economy.

Database (AO1)

A **database** is a computerized system that makes it easy to store, search and select data and information. In the same way that a public library stores a large range of books, a database stores a large volume of data and information that is used by a business. With computerised systems and structures, businesses can input, organize, save, protect and retrieve data in an efficient way (in terms of speed and accuracy).

Businesses will typically use databases to keep track of information about customers, employees, inventory (stock) and accounting information. For example, a shoe retailer that sells a range of different types of footwear will need to keep records of the sales of the different shoes sold (such as the type, size and colour of the shoes) as well as important details about the customers. Similarly, schools are likely to use a database to keep track of each student's personal details, such as their name, age, year group, home address, details of the parents or legal guardians, medical records, attendance and punctuality records and emergency contact details. Schools will also have a similar database for their staff, as well as records of their ongoing professional training and career development.

In the digital age, the disadvantages of using databases are minimal, but include the initial set-up costs as well as ongoing maintenance costs, such as the cost of hiring database managers. There is also the potential risk of cybersecurity (see below). Nevertheless, the reliance of businesses on accurate financial records, secure credit card accounts, efficient billing and invoicing and important customer records are all valid reasons why databases are so important for businesses.



Figure 43.1 - Manual database systems are highly inefficient

Cybersecurity and cybercrime (AO1)

Cybersecurity refers to the protection of computer systems and networks from unwarranted information disclosure, as well as theft of or damage to computer hardware, software or data. It is used to protect businesses and individuals against cybercrime.

Cybercrime refers to any illegal activity carried out using computers or the Internet by deliberately and maliciously targeting computers, computer networks or networked devices. Cybercrime can be carried out by individuals or organizations and is usually done for financial reasons (profit), but in some cases can be caused by political or personal motives.

With the increased reliance on e-commerce and the growing popularity of a cashless society, cybercrime is becoming more of a threat to people and businesses across the world. Examples of interrelated cybercrime include:

- Phishing - This is the use of fraudulent messages designed by the attacker to trick victims into revealing sensitive information.
- Ransomware - This is the use of malicious software from cybercriminals who threaten to publish the victim's personal data or permanently block access to the data unless a ransom is paid to the attackers.
- Email and internet fraud - This refers to the use of enticing messages in emails and text messages, such as "Tap on this link and claim your $1 million today!"
- Identity theft - This occurs when an individual's private information is stolen and used without any permission.
- Account hijacking - This occurs when an individual's private or profession account (such as email, social media or bank account) is stolen and abused or misused. This includes hijacking a company's website and shutting it down completely.
- Intellectual property theft - This is the piracy or theft of materials that legally belong to others, such as copyright infringements and counterfeiting of registered trademarks (see Chapter 42).



Figure 43.2 - Cybersecurity is an increasingly important issue for businesses

Businesses can protect themselves against cybercrimes by improving their cybersecurity systems and processes. This includes methods such as:

- Keeping computer software, network structures and operating system updated.
- Using anti-virus software to prevent or limit the volume of cyberattacks.
- Training staff about the importance of cybersecurity and practical strategies such as:
    - o never opening unsolicited email attachments
    - o using stronger security passwords (and updating these at appropriate times) and
    - o being extremely cautious when disclosing private or confidential information.

HIGHER LEVEL

Operations management

Critical infrastructures

Critical infrastructures, including (i) artificial neural networks, (ii) data centres and (iii) cloud computing. AO2

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Critical infrastructure refers to the essential and interrelated physical structures and facilities needed for the effective functioning of a business. These include, but are not limited to, (i) artificial neural networks, (ii) data centres and (iii) cloud computing.

(i) Artificial neural networks

Artificial neural networks (ANN) are a form of machine-learning that use learning algorithms that can independently make adjustments as they receive new input. This means that ANNs can solve problems without having to be explicitly programmed with rules to follow, in a similar way to that of the human brain. This means ANNs are the basic building blocks of artificial intelligence (AI).

ANNs can be used for many business applications, such as natural language processing in chatbots (used for interacting online with customers) and predictive analysis for detecting spam email and phishing text messages.

Inspired by the structure of the human brain, artificial neural networks are used to make computers or machines more human like in terms of their use of reasoning, intuition and even imagination. ANNs were first developed back in the 1950s to address the issue that computers cannot interpret the context of real-world situations or apply common sense to problems in the way that human brains are capable of.

Examples of business applications of artificial neural networks include:

- Google uses ANN learning algorithms to make its 'watch next' recommendations for YouTube videos.
- Facebook uses ANNs for its DeepFace facial recognition system, which uses algorithms to recognize faces with around 97% accuracy.
- Microsoft's Skype uses ANN to do translations of live online conversations.
- Commercial banks, such as HSBC, use chatbots to deal with customer queries in real-time.



Figure 43.3 - Chatbots are used by an increasing number of retail businesses

(ii) Data centres

A **data centre** is a physical facility or space of networked computers and component resources that supports businesses in housing their critical applications and data. The main components of a data centre include routers, firewalls, secured storage systems, mainframe servers and application-delivery controllers.

Most businesses rely heavily on data for their day-to-day operations, regardless of the industry or nature of the data. Data centres enable a large volume of data to be stored, organized, processed and distributed by businesses. Services provided by data centres to support business applications and activities include:

- Data backup and archiving of important files, documents and records.
- Email and file sharing
- Database systems
- Big data, artificial intelligence (AI) and machine learning
- Virtual communications and collaboration services.

All of this means that data centres are vital to the continuity of a business as they house an organization's critical and valuable assets needed for its daily operations. The world's largest data centre is the Citadel Campus at Tahoe Reno Industrial Centre

(TRIC), located in Nevada, US. The data centre is spread over 1,000 acres and has up to 7.2 million square feet of data centre space.



Figure 43.4 - Data centres are used by businesses in every industry

(iii) Cloud computing

Cloud computing is similar to data centres except that it is a virtual resource or online space that enables businesses to store, organize and retrieve data in safe and efficient ways. As with data centres, cloud computing requires the use of computer networks and remote servers, which possess a unique function.

However, there has been a shift in critical infrastructure from traditional on-premises physical servers in data centres to virtual networks that support work applications and data management in a cloud environment. The 'cloud' is not a physical entity but a virtual service and is accessed via an Internet connection. At the most basic level, cloud computing storage services include Google Drive, Microsoft One Drive, iCloud and Dropbox. Other examples of cloud services providers for businesses include Amazon Web Services (AWS), Microsoft (Azure) and IBM Cloud. Some of the differences between data centres and cloud computing are outlined in Table 43.1 below.

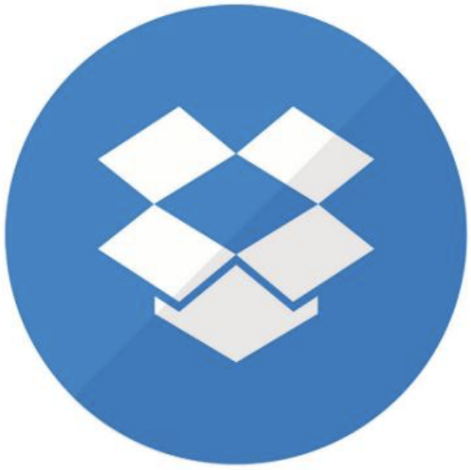

Figure 43.5 - An increasing number of businesses rely on cloud computing providers such as Dropbox

Theory of Knowledge (TOK)

If something is in the "cloud", how can we know it really exists? Is sense perception a hindrance to knowledge?

Table 43.1 - Data centres versus cloud computing

Data centres	Cloud computing
A physical resource that helps businesses to store, organize and retrieve data in an efficient and safe way.	A virtual resource that helps businesses to store, organize and retrieve data in an efficient and safe way.
The investment costs are significant compared with cloud computing.	The investment costs are insignificant compared with data centres.
Maintenance costs are high, including hardware engineers, developers, security and temperature monitoring systems.	Maintenance costs are relatively low, such as the need for software engineers and fees paid to cloud services providers.
It does not rely on having Internet or Wi-Fi connections, as Ethernet cables are used.	Requires a stable Internet or Wi-Fi connection to provide the function.

Virtual reality (AO2)

Virtual reality comes from the words "virtual" (meaning near) and "reality" (meaning what we experience as human beings). Hence, virtual reality (VR) means near-reality. It an artificial, three-dimensional environment that is created with software and presented to the user in a near-reality way that people can explore and interact with. VR technologies enable users to experience things through the senses of sight and sound in a three-dimensional and interactive environment.

VR has both entertainment and commercial use. It is commonplace in the corporate world. For example, airline companies use VR technologies to create computer generated virtual environments for flight simulations used to train and test pilots. This creates a realistic, albeit safe, environment for pilots training to handle potential hazards and challenges during a flight, such as adverse weather conditions and emergency landing protocols.



Figure 43.6 - Flight simulations are a vital part of training for pilots

With VR becoming cheaper and more widespread, analysts expect to see many more possibilities and uses for the technology in the future. Examples of the use of VR in education are outlined in Box 43.1. Nevertheless, the set-up costs can still prove to be expensive, especially if the content needs to be customized and engaging.

Box 43.1 - The use of VR in education

Examples of how universities and schools use VR include:

- VR enables students to visit different locations (including other schools or learning spaces) across the world without having to leave the classroom or to incur the expenses and inconveniences associated with travel.
- Using VR to teach younger children about road safety.
- In Science, students can explore the human brain and other organs.
- In History, they can take virtual tours of Ancient Rome, explore the pyramids of Giza, or even board the Titanic.
- VR provides students with memorable, engaging and immersive experiences. It enhances student learning through better or more inspiring experiences.
- Once set up, VR is accessible to all students and can be easily monitored by their teachers.

ATL Activity 43.1 (Research skills)

VR is used in many industries, such as architecture, the Arts, car manufacturing, education, entertainment, healthcare, law enforcement, retail, sports and tourism.

Investigate how VR is being used in any **one** of the above industries. Be prepared to share your work with your teacher.

Key concept

Discuss how virtual reality encourages **creativity** in business organizations.

The internet of things (AO2)

The **Internet of Things** (IoT) refers to a broad system of physical objects embedded with electronics, software and sensors that connect to the Internet. These devices are able to collect, transfer and store huge volumes of data over the Internet in real time. Hence, the physical objects (or 'things') are also referred to connected devices through wireless and Bluetooth technologies. Examples include smart devices (such as smartphones, smart heating systems, office security devices and home appliances) as well as wearable technologies.



Figure 43.7 - The Internet of things has unlimited applications for businesses

For example, in the healthcare industry, wearable smart devices are an application of the IoT. They can be used to keep records of health-related data for health clinics, hospitals and health insurance providers. Doctors or surgeons, for example, can use a large volume of statistical data of their patients so that the best form of treatment can be applied in a timely manner.

Car manufacturers and car dealerships use data from each vehicle to offer customers an appointment for servicing (maintenance), to get their parts fixed, send customers directions to the nearest dealer or garage and make sure the correct replacement parts are ordered so they are ready for when the customer arrives. Hence, the IoT helps businesses to operate in a more lean and efficient way (see Chapter 37) and can generate significant competitive advantages.

The purpose behind the Internet of Things is for connected devices that self-report in real-time so that the data can be used to improve efficiency. It removes the need to depend on human intervention to collect, process and interpret important information. Moreover, the IoT is able to do this far more quickly and accurately, in real-time.

The Internet of Things generates massive volumes of data from countless devices that are permanently connected to the Internet. The personal and business possibilities of this are only limited by imagination and creativity. However, due to the vast amount of data involved with the IoT, businesses also need to operate within the law governing the collection, storage and transfer or sharing of data.

Case study 43.1 - Smart devices



Amazon's Alexa, Google's Home and Apple's Siri (digital voice assistants) are examples of widely used consumer IoT applications that are increasingly integral to the daily lives of billions of people. Users can talk to digital voice assistants like Alexa for a wide and growing variety of functions including playing music on demand, reporting live news coverage, providing weather reports, asking questions about literally any topic, calling family and friends, setting reminders and alarms, ordering an Uber and so much more.

The main advantage of the IoT is that it improves efficiency (minimizing human effort and saving time to get tasks done). Enhanced data collection and access to real-time information also help with rational decision making. However, the main concerns evolve around the issue of data security and privacy concerns. There could also be concerns about the growing dependency on the Internet and hence the inability for businesses to function efficiently without it.

Artificial intelligence (AO2)

Artificial intelligence (AI) is an aspect of computer science that focuses on the ability of smart machines to perform tasks that typically require human intelligence, such as voice commands on a smartphone or in a car. AI enables intelligent machines to work and react like humans. However, AI has the ability to boost operational efficiency and complete highly complex tasks that cannot be easily managed by human beings.

Hence, AI provides many opportunities for businesses to boost productivity in cost-effective ways.

For example, AI is commonly used in the car manufacturing industry. Satellite navigation, with global positioning systems, automatically gather, process and evaluate real-time driving conditions for motorists, helping them to follow the optimum route with AI guidance to help avoid congested roads as well as other road hazards. An increasing number of car manufacturers are using AI to develop and produce autonomous vehicles (AV) that are self-driving. Such vehicles are equipped with multiple sensors, such as cameras, radars and lidar (used to calculate ranges and variable distance for speed and breaking). These sensors generate a huge amount of instantaneous data, along with machine learning technologies, to process and validate the vehicle's autonomous driving systems. **Machine learning** is a subset of AI that includes algorithms that can memorize on their own and anticipates results without anyone explicitly programming the system to do so.



Figure 43.8 - Autonomous vehicles rely on AI technologies

Other examples of the use of artificial intelligence in the business world include:

- Human resource management - Artificial Intelligence is being increasingly used for hiring (recruiting) workers. With hundreds of candidates potentially applying for a single vacancy in an organization, many businesses use AI and language processing software to filter through the curricula vitae (résumés) and shortlist the suitable candidates who meet the employer's requirements. This is done by analyzing different attributes of the candidates (such as their skills, experience and qualifications) in line with the job description and person's specifications.
- Cybersecurity - This is one of the most important applications of AI for businesses. Given the reliance on online technologies, such as the storage of important databases of financial data, business plans, private information about employees and so forth, the use of AI to understand, detect and remove unwanted cyber threats is paramount to the operations of businesses.
- Data analysis - AI enables businesses to collect and process a huge amount of data to provide feedback and predictions about changing customer needs and preferences. This enables the business to provide better customer experiences and marketing strategies that engage customers and build brand loyalty. For example, social media platforms use targeted adverts based on the massive volume of data collected from people's smartphones and mobile devices.
- Financial management - Artificial Intelligence has made financial management much easier for businesses by automating billing and invoicing systems and the subsequent recording of financial data. Electronic invoices and financial filing are easier to handle (and far more efficient than manual data input systems). For example, many small businesses have benefited from the use of AI technologies from providers such as PayPal to automate payment systems as well as provide data analytics to support financial planning.
- Automated customer services - The use of AI and machine learning can improve customer engagement and improve the quality of services without the need to hire so many workers. For example, AI allows search engines to be smarter and online chatbots used by banks and retailers to be more helpful in meeting the needs of customers.

Case study 43.2 - Hellenic Post

In 2022, Hellenic Post, the state-owned provider of postal services in Greece, launched a fleet of 55 postal robots to speed up its sorting and delivery services. Using AI technologies, the four-wheeled autonomous mobile robots scan the postal code on up to 168,000 parcels weighing a maximum of 15kg each day. Directed by sensors, the robots sort the parcels and deliver these into the corresponding mail sacks set up around Hellenic Post's sorting office. Up to 80% of Hellenic Post's parcel sorting has been handed over to these robots.

Whilst there are many opportunities and benefits of using and developing AI in the corporate world, it can be a highly expensive investment. Critics are also doubtful about the potential misuse of artificial intelligence as well as the impact on employment in many sectors of the economy.

Big data (AO2)

Big data is the process of collecting and analysing large amounts of data sets in order to identify trends and patterns that can be used in strategic planning and business decision-making. Businesses have huge potential to harness big data in digital format to help them to understand their customers better.

Data sets are very important for any business as they can help firms to enhance their marketing strategies, such as advertising campaigns that target the right customers in the right way. Big data can also enable businesses to offer a more bespoke (personalised) service to meet the needs and preferences of their clients.

There are many reasons for the exponential growth in big data, including the data gathered from:

- E-commerce, such data collected from shopping carts and online purchases.
- Use of logistics and transportation systems that use electronic ticketing systems and location data using GPS technologies (global positioning system).
- Social media data, from interactions on platforms such as Facebook, Instagram, LinkedIn, Snapchat, Twitter and WhatsApp.
- The Internet of Things (IoT), such as data generating from smartphones, mobile apps and smart appliances in the home or office.

Hence, big data and data analytics are significant for the growth and development of any business organization, which supports the business in optimizing its performance. As stated by Angela Ahrendts, Apple's former Senior Vice President, "Consumer data will be the biggest differentiator... whoever unlocks the reams of data and uses it strategically will win". Similarly, Ginni Rometty, former CEO of IBM, said "Big data will spell the death of customer segmentation and force the marketer to understand each customer as an individual."



Figure 43.9 - Big data is used to optimize the performance of businesses

Businesses use big data in several ways. Some examples include:

- *Generating marketing insights* - Big data can generate important insights to the changing needs and wants of customers, based on data gathered e-commerce data analytics and social media posts, for example. Big data has revolutionized traditional methods of market research (see Chapter 26).
- *Tracking and monitoring* - Access to big data helps a business to have better control over its operations. For example, transportation companies use big data for capacity management, which is also important for ensuring the safety of their customers. Hence, big data can help businesses to improve their overall efficiency and financial performance.
- *Improved decision-making* - Big data enables businesses to use and analyse information in real-time to aid decision making. For example, airline companies and mobility service providers (such as Uber) use big data for dynamic pricing strategies (see Chapter 28) as well as for other elements of the marketing mix (see Chapters 27 - 33).

Key concept

What **ethical** issues arise due to the exponential growth in big data in the corporate world? Consider the notions of data security and data privacy in your answers.

Business Management Toolkit

Discuss the value of descriptive statistics (see Chapter 50) in understanding the value of big data to businesses.

Customer loyalty programmes (AO3)

A **customer loyalty programme** refers to any customer-retention strategy that incentivizes customers to continue buying the same products and brands of the business, instead of switching to those provided by competitors. They are used to encourage repeat purchases by using different reward programmes. For example, reward points accumulated on loyalty schemes can be redeemed for special discounts or gifts.

Some customer loyalty programmes are so successful that they have become a long-term strategy to promote an organization's products or brands, such as airline frequent flyer programmes or customer loyalty programmes used by supermarket chains.

Customer loyalty programmes are a marketing approach designed to improve customer relationships and to ensure both parties feel that they are getting something beneficial from this. So, customers provide their ongoing support by making repeat purchases or engaging with a brand on a recurring basis. In return for their loyalty, customers receive loyalty rewards, such as discounts, rewards coupons or freebies (free gifts).

The main argument for using customer loyalty programmes, despite their cost, is that the spending to retain customers is far cheaper than the spending needed to attract new customers. Loyalty programmes tend to work because they make customers feel special and valued, which further leads to customer retention, more referrals (word of mouth recommendations) and therefore higher profits in the long term.

By contrast, without a loyalty programme, customers might simply walk away permanently, meaning the business loses this revenue stream forever. Winning the loyalty of customers is so important that many businesses have switched to using a subscription model to collect reoccurring payments from customers. For services, customers get new content on a regular basis (such as in the case of Netflix or InThinking Business Management). In the case of goods, loyal customers must feel they get value for money (such as in the case of coffee shops that use subscription models). Subscribers represent customers who have pledged their allegiance to the business.



Figure 43.10 - Many businesses use subscriptions to retain their customer base

The most basic form of loyalty programmes offers customers greater rewards based on the value or volume of purchases or visits made, such as a clothes retailer, theme park or cinema. Many airline companies offer frequent flyer programmes whilst hotel chains offer loyalty points based on the amount spent by customers. Amazon Prime customers, who pay for the privilege, enjoy membership benefits such as free shipping and digital. media streaming services.

For customer loyalty programmes to work, a huge amount of data is needed to ensure the rewards reflect what customers actually want and that the costs of operating the rewards programme does not outweigh the benefits. This requires businesses to collect, process and store data, such as customer spending habits (like the most frequently bought items, the frequency of purchases per time period and the average spend per transaction). It may also include gathering regular feedback from customers. This data enables businesses to determine the best marketing strategies to use to target, entice and retain customers. Listening to customers is important not only to be able to develop sustainable loyalty programmes, but also to improve the overall customer experience so as to establish a loyal customer base.

The use of data to manage and monitor employees

The use of data to manage and monitor employees; Digital Taylorism. AO3

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Digital Taylorism is a modern approach to F.W. Taylor's scientific management method of management and motivation (see Chapter 10). Taylor (1856 - 1915) suggested that the best way to boost productivity in the workplace is a combination of three strategies to manage staff and tasks in a scientific or methodical way:

1. Specialization and division of labour by breaking down complex tasks into simple ones.

2. Measure everything that workers do so tasks and productivity can be measured.

3. Link pay to performance using a differentiated payment system (awarding more productive workers, such as bonuses and pay rises and sanctioning those who do not meet targets or standards set by management).

Taylorism is based on developing policies and practices that maximize efficiency and productivity by standardizing work processes and techniques for completing each task. Digital Taylorism is found in organizations that use data and surveillance (monitoring) systems to monitor employees to ensure they remain on task at all times. The number of firms using such systems is continually growing. The Economist has described Amazon and FedEx as a digital Taylorism corporate culture, arguing that "what gets measured, gets managed."

Common methods of staff monitoring systems include software monitoring (to track what employees are doing on their computers), telephone recordings, video surveillance, email monitoring and location monitoring. Electronic monitoring systems and digital tools to gather data provide managers with the ability to continuously evaluate and measure the performance of employees, irrespective of whether they are in the office or working from home. There are plenty of options available to businesses, including a growing number of online staff monitoring apps such as Workpuls (https://www.workpuls.com), which specializes in data analytics for workforce productivity.



Figure 43.11 - Monitoring systems are an integral part of digital Taylorism

On the surface, it may seem that employers monitor workers because they do not trust their employees. However, using data and surveillance systems to monitor employees can have positive impacts. For example, many businesses record telephone conversations between staff members and customers, so that these can be used for training purposes and to improve the level of customer service. The interrelated benefits of using data and staff monitoring systems include:

- *Freeing up management time* - It is not humanly possible for individual managers to have complete oversight of every employee, for every operation, in every location and at all times. It is therefore more practical to use staff monitoring systems to collect the data needed to monitor and support staff accordingly.

- *Improved coordination and control* - Using data and staff monitoring systems enables employers to know everything that is going on in their business at all times. This includes identifying areas where workers need to improve their performance as well as spotting employees who might be violating company policies. There will always be dishonest people in the workplace, especially in very large organizations that have many employees.

- *Training and development* - Data used to monitor employees can be used to fix mistakes and to improve performance. For example, most IB World Schools use examination data to inform school leaders about the quality of teaching and learning. Teachers are recognized for their areas of strength and supported in areas that may need some improvement or development.

- *Improved productivity and efficiency* - People tend to be more focused on their work and less distracted if they know they are being monitored. For example, you might notice a slightly different approach and attitude of educators when by they are being observed by senior management. In theory, the data and information collated from such observations helps to improve the overall productivity in the workplace.

- *To reward employees* - As with any form of scientific management, digital Taylorism rewards more productive workers who meet or exceed targets. for example, data can reveal which individual employees or teams have contributed the most to the firm's sales revenue. Furthermore, monitoring systems can provide evidence of the many instances when employees go above and beyond what is expected of them.

- *To improve the appraisal process* - Through continuous and improved methods of performance monitoring, managers can gain a better understanding of each individual worker's strengths and weaknesses. Arguably, staff can only achieve optimal outcomes if they receive regular and effective feedback. The use of data during appraisal meetings or discussions (see Chapter 10) can help employees to grow and develop professionally. Hence, the appropriate use of data can increase staff motivation and the desire to succeed.

- *To prevent illegal behaviour in the workplace* - Employers might choose to monitor the use of computers in the workplace to protect the business from legal issues that could arise if employees engage in inappropriate or illegal online activities.

However, there are laws that protect employees from the misuse of data and surveillance systems in the workplace. For example, privacy laws prevent any form of surveillance in staff bathrooms (washrooms). Such laws help to alleviate some of the concerns of employees who are being observed in the workplace.

Note that monitoring employees in secret without their knowledge or consent is considered in most parts of the world to be both unethical and illegal. However, this practice can be considered legal when employers have genuine reasons to suspect malpractice and need to gather the evidence to discipline or dismiss the employee in a lawful way. Apart from this, if firms simply want to keep an eye on their employees without informing them, there could be serious legal consequences.

Theory of Knowledge (TOK)

To what extent is it ethical for an employer to scrutinise the social media posts of a prospective employee (job applicant)?

Key concept

Discuss the extent to which employee surveillance in the workplace is **ethical**.

Data mining

The use of data mining to inform decision making. AO3

IBO, 2022

Data mining is the process of extracting raw data from large amounts of different data sets and summarizing this, using intelligent methods, into useful (usable) information in a coherent structure for further use. This enables businesses to solve problems, minimize risks and make the most of new opportunities. Used correctly, data mining creates competitive advantages for a business to learn more about customers, develop effective marketing strategies, increase revenue and decrease costs.

Data has become an important priority for businesses in every industry and in all aspect of their operations. With the massive volumes of data available, data mining relies on the use of powerful computers and sophisticated algorithms to execute a range of statistical techniques to extract data that are of real value. This is then analyzed in various ways in order to identify patterns, trends and relationships. Data mining covers the topics of big data, data analytics, artificial intelligence, machine learning and database systems.

Data mining is a particularly useful technique to support a firm's marketing competitiveness. For example, a common use of data mining is to break down the vast amount of data about customers into meaningful segments such as age, gender, race, income and occupation. Ultimately, data mining is used to help managers to make more-informed business decisions. Data mining has many business applications, such as:

- *Consumer profiling* - to examine customer purchasing patterns and making connections of the data to consumer demographics (see Chapter 24) in order to make better marketing decisions.

- *Marketing planning* - using meaningful data to inform a business about its segmentation, targeting and positioning strategies (see Chapter 24).

- *Sales forecasting* - to identify sales trends and to make accurate sales predictions based on data about customer spending habits (see Chapter 25).

- *Market research* - to develop improved marketing campaigns (see Chapter 26). Data mining can be used to predict what customers might want to purchase in the future, based on data collected about their past purchasing habits (see Case study 43.3 below).

- *Customer loyalty schemes* - businesses such as supermarkets use mined data to retain customers by developing appropriate reward programmes.

- *Market basket analysis* - retailers use data mining techniques to gain a better understanding of customer purchasing patterns based on items purchased in the past or items placed in a basket (on an e-commerce platform).

- *Production planning* - to support smart inventory control systems as well as to identify any gaps and errors in production processes, such as bottlenecks in supply chains (see Chapter 40).

- *Research and development* - to inform R&D expenditure, product development and innovation strategies based on the predicted needs and preferences of customers (see Chapter 42).



Figure 43.12 - Data mining has many wide-ranging business applications

Case study 43.3 - Walmart, Hurricanes and Strawberry Pop-Tarts

So, what do Walmart, Hurricanes and Strawberry pop tarts all have in common? It is common for households to panic buy essential grocery items (such as milk, bread, rice, potatoes and eggs) when there are announcements made about imminent severe weather conditions. However, according to data mining by Walmart in 2017, customers in the US also purchase up to seven times more Strawberry Pop-Tarts ahead of a hurricane. Walmart Said that Strawberry Pop-Tarts are one of the pre-hurricane top-selling food items as they do not require heating, can be eaten at any meal and have a long shelf life. Walmart has used data mining and predictive technologies since 2004.

Case study 43.4 - Data mining and customer loyalty programmes

Retailers such as supermarkets are established users of data mining techniques. Many supermarkets offer free loyalty programmes to customers. Loyalty cards are used to offer customers reduced prices and special offers that are not available to non-members. The magnetic strips on customer loyalty cards make it easy for retailers to track what customers are buying, the quantities in which they buy these, when they are buying the products and at what price. After mining the data, supermarket stores can then use this information to execute more suitable marketing strategies to target and retain their customers.

However, the use of data mining has come under scrutiny and criticism especially when users, employees or customers are unaware of their data being collected and mined, often for commercial gain. The selling, sharing or redistribution of personal information without the prior knowledge and approval of owners is unethical and illegal in many countries, especially when the data are used to influence preferences and decision making. For example, numerous social media companies have been severely criticized for using data mining techniques to generate profits.

Nevertheless, data mining enables a vast amount of useful information to help businesses to increase their sales revenues, cut costs, improve customer relations management and reduce risks. As stated by Carly Fiorina, former CEO of Hewlett-Packard, "*The goal is to turn data into information and information into insight.*" Essentially then, data mining is a powerful tool for increasing the profits of a business.

Business Management Toolkit

To what extent might the use of management information systems (MIS) can facilitate the implementation of circular business models. You can wish to refer to Chapter 51 prior to answering this question.

Theory of Knowledge (TOK)

Is data mining ultimately anunethical use of private data?

HIGHER LEVEL

Management Information Systems (MIS)

The benefits, risks and ethical implications of advanced computer technologies (collectively referred to here as Management Information Systems) and technological innovation on business decision making and stakeholders. (AO3)

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Management Information Systems (MIS) refers to the study of advanced computer technologies and their impact on organizations, people and the relationships among them. It is about people, processes and technology in an organizational context. MIS covers the entire contents of this chapter: data analytics, databases, cybersecurity and cybercrime, critical infrastructures (including artificial neural networks, data centres and cloud computing), virtual reality, the Internet of Things, artificial intelligence, big data, customer loyalty programmes and the use of data to manage and monitor employees (digital Taylorism).

The advantages of MIS have been outlined in the various sections of this chapter. If set up and used appropriately, a Management Information System enables businesses to have better coordination, control, analysis and visualization of data and information relevant to the operations of the organization. Ultimately, the use of MIS enables managers to make better informed decisions by having flexible and speedy access to accurate data in order to achieve the goals and objectives of the organization.

However, the opposite in the use and over reliance of MIS in business organizations. examples include hardware and software failure, cybercrime and data privacy. The monitoring of employees in the workplace can be controversial and may cause conflict between employers and employees because both stakeholder groups try to protect their personal interests. Employees want to maintain their privacy while employers want to ensure workers don't abuse their privileges or misuse (waste) the firm's scarce and valuable resources. To minimize the potential conflict, businesses can ensure their Management Information Systems, such as staff monitoring policies and practices, are implemented in transparent, indiscriminate and ethical ways. For example, organizations that opt to monitor their employees' online activities can install software on work computers and mobile devices that block access to specific websites (such as online gaming sites) or restricts the amount of time that employees can spend on certain Internet sites that are not directly related to their jobs.

Employers can establish respect for the privacy of their employees by creating clear policies that define the parameters of acceptable and unacceptable uses of company computers and other devices or equipment. The policies should also specify the organization's right to monitor the work of employees, including online activities, as well as the consequences for violating the rules.

As previously mentioned, monitoring employees in secret or even outside of work hours, without their prior knowledge or permission is unethical and likely to be illegal. The same applies to the monitoring and surveillance of customers. Collecting and storing personal data of customers and employees that an organization does not actually need in order to function as a business entity also raises ethical questions about the (mis)use of Management Information Systems in the corporate world.



Figure 43.13 - How do we determine whether it is ethical to monitor the work of employees?

Key concept

Discuss the role of data in the **sustainability** of business organizations.

Theory of Knowledge (TOK)

Do management information systems enable businesses to know us better than we know ourselves?

Question 43.1 - Meta

In early 2022, Meta was accused of abusing its market dominance in the UK to sell personal data of its 44 million Facebook users. This led to a multi-million-dollar lawsuit against the social media giant. The litigation case came only several months after the US Federal Trade Commission was given the go-ahead to take Meta to court over antitrust rules used to protect consumers by blocking monopolies that take advantage of their customers.

UK laws protect individuals from being harmed in any way, financially or otherwise, caused by Management Information Systems such as **Internet of Things** (IoT) and **artificial intelligence** (AI) to mine personal data. In response to the accusations, Facebook said its users have "meaningful control" of what data and information they choose to share on the social media platform.

(a) Distinguish between the Internet of Things (IoT) and artificial intelligence (AI). *[4 marks]*

(b) Discuss the ethical implications of advanced computer technologies in organizations such as Meta. *[10 marks]*

REVIEW QUESTIONS

1. What is meant by data analytics?
2. What is a database?
3. What is cybersecurity?
4. Why is cybercrime an issue for businesses?
5. In the context of Management Information Systems, what is meant by critical infrastructure?
6. What are artificial neural networks?
7. What are data centres?
8. What is meant by cloud computing?
9. What is virtual reality?
10. What is the Internet of Things (IoT)?
11. What is artificial intelligence (AI)?
12. What is meant by machine learning?
13. What is big data?
14. What are customer loyalty programmes?
15. What is digital Taylorism?
16. How do employers use data to manage and monitor employees?
17. What is data mining?
18. How does data mining differ from data analytics?
19. What are Management Information Systems (MIS)?
20. What are the ethical issues that arise from using Management Information Systems (MIS)?

KEY TERMS

Artificial intelligence (AI) is an aspect of computer science that focuses on the ability of smart machines to perform tasks that typically require human intelligence, such as voice commands on smart devices.

Artificial neural networks (ANN) are an aspect of critical infrastructure which uses learning algorithms that can independently adjust as they receive new input. They solve problems without having to be explicitly programmed with rules to follow.

Big data is the process of collecting and analysing large amounts of data sets in order to identify trends and patterns that can be used in business decision-making.

Cloud computing is a virtual resource or online space that enables businesses to store, organize and retrieve data in safe and efficient ways.

Critical infrastructure refers to the essential physical structures and facilities needed for the effective functioning of a business.

A **customer loyalty programme** refers to any customer-retention strategy that rewards or incentivizes customers to continue buying the same products and brands of the business.

Cybercrime refers to any illegal activity carried out using computers or the Internet by deliberately and maliciously targeting computers, computer networks or networked devices.

Cybersecurity refers to the protection of computer systems and networks from unwarranted information disclosure, as well as theft of or damage.

Data analytics is the process of transforming raw data into usable information for businesses.

A **database** is a computerized system that makes it easy to store, search and select data and information.

A **data centre** is a physical facility or space of networked computers and component resources that support businesses in housing their critical applications and data.

Data mining is the process of extracting raw data from different data sets and summarizing this into usable information in a coherent structure for further use.

Digital Taylorism is a modern approach to scientific management, with the use of Management Information Systems to establish the best way to boost productivity in the workplace by managing staff and tasks in a methodical way.

The **Internet of Things** (IoT) refers to electronic devices that are able to connect to the Internet and share, transfer and store data with other Internet-enabled devices (or 'things').

Machine learning is a subset of AI that includes algorithms that can memorize on their own and anticipates results without anyone explicitly programming the system to do so.

Management Information Systems (MIS) refers to the study of advanced computer technologies and their impact on organizations, people and the relationships among them.

Virtual reality (VR) is an artificial environment that is created with software and presented to the user in a near-reality way.



Figure 43.14 - How do we know what reality really is?

Business Management Toolkit

"A good tool improves the way you work. A great tool improves the way you think."
- Jeff Duntemann (b.1952), American science fiction author

What is the Business Management Toolkit (BMT)?



The Business Management Toolkit (BMT) is an integral feature of the new course, consisting of fifteen tools that can be used by students in different contexts across the contents of the Business Management syllabus, providing synthesis and connectivity to the different units of the course. This includes all forms of assessments, such as the examination papers for external assessment, the internal assessment (IA), as well as the extended essay (EE).

The BMT is part of the syllabus content (in addition to the 5 units of the syllabus) but it is expected that teachers will integrate the toolkit throughout the teaching of the course. It provides a valuable set of tools (or frameworks) for students to analyse different topics and situations in the context of new Business Management course.

The BMT is comprised of fifteen tools prescribed in the IB syllabus that provide synthesis and connectivity across the entire contents of the DP Business Management course. Of these 15 tools, eight apply to SL students, with seven being HL only tools. HL students are expected to be able to use all fifteen of these tools in the BMT.

The intention is that the BMT is integrated throughout the two-year course and can be applied to different content and in different contexts.

The Business Management Toolkit

SL & HL tools	HL only tools
Ansoff matrix	Contribution
BCG matrix	Critical path analysis
Business plan	Force field analysis
Circular business models	Gantt chart
Decision trees	Hofstede's cultural dimensions
Descriptive statistics	Linear regression
STEEPLE analysis	Porter's generic strategies
SWOT analysis	

Note that the BMT is actually part of the syllabus content, although teachers are expected to reinforce these tools by integrating the toolkit to examine and evaluate the syllabus content throughout the two-year course. The IB also recommends that teachers:

- teach the contents of the syllabus by integrating the tools in the BMT.
- use local, national, and/or global case studies to add real-world context when applying the BMT.
- incorporate the BMT in class discussions and debates about the effectiveness of particular tools in different situations.
- use the BMT in both formative and summative assessments.

Throughout the textbook and in each chapter, there are references to the Business Management Toolkit to provide suggestions for how you can link this to the contents of the syllabus. This serves to help the reader to see the tools in action as well as show how the tools can be integrated into the IB Business Management course. However, note that these are suggestions only and teachers are free to use other alternative or additional approaches.

Top Tip!

As you use each of the prescribed tools in the BMT, consider the following:

- Its purpose
- Its value (advantages or benefits), and
- Its limitations (disadvantages or drawbacks)

What are the classifications of the BMT?

"It is essential to have good tools, but it is also essential that the tools should be used in the right way."
Wallace D. Wattles (1860 - 1911), American author of *The Science of Getting Rich*

Each of the fifteen tools in the BMT can be classified in three ways: (i) situational tools, (ii) planning tools or (iii) decision-making tools.

- **Situational tools** are used to assist managers and entrepreneurs to assess aspects of the internal and external factors affecting their business. Examples of such tools include SWOT analysis, STEEPLE analysis and descriptive statistics. Situational tools help decision makers to address the question "Where are we now?"
- **Planning tools** are used to assist managers and entrepreneurs to prepare and implement specific projects and developments. Examples of such tools include business plans, Gantt charts (HL only) and critical path analysis (HL only). Such tools help managers and entrepreneurs to organise resources efficiently and to complete a project or business venture on time. Planning tools help decision makers to address the question "Where do we want to get to?" or "Where do we want to be?"
- **Decision-making tools** are used to assist managers and entrepreneurs to make informed choices and judgements by considering different quantitative and/or qualitative factors. Decision making is a key role of managers and entrepreneurs. Examples of decision-making tools include the Boston Consulting Group (BCG) matrix and the Ansoff matrix. Decision-making tools help managers and entrepreneurs to address the question "How do we get there?"

Note: It is not always helpful nor necessary to classify the tools in the above ways because the BMT may have overlapping applications to the contents of the course. Hence, it is possible that a particular tool can apply to more than one of the above classifications.

Top Tip!

Managers and entrepreneurs have good judgement. Sometimes, this judgment is due to their intuition (or gut feeling), which is often based on their experience, expertise, and/or personal preferences. *Intuitive decision-making* can lead to quick decisions being made. However, for more strategic decisions, relying only on intuition can be highly risky as the choices are not necessarily supported by any research or data. Hence, managers and entrepreneurs often use a variety of BMT to ensure their decision making is objective, rational and logical. This is referred to as *scientific decision-making*. This helps to reduce the risks of making mistakes.

Integrating the BMT

The table below provide just one model of how the prescribed tools in the BMT can be used to integrate the contents of the syllabus with appropriate context using real-world examples. By the end of each section of the syllabus or each chapter in this textbook, aim to be able to apply, analyse and assess the various tools in the BMT.

Please note that the table following is not exhaustive and that teachers are free to adopt their own approach to integrating the BMT in the delivery of the syllabus content.

Tools	Classification of tool	Units of the syllabus				
		1	2	3	4	5
Ansoff matrix	Decision-making	✓			✓	✓
BCG matrix	Situational Decision-making			✓	✓	
Business plan	Planning	✓	✓	✓	✓	✓
Circular business models	Decision-making	✓	✓			✓
Decision trees	Planning tool Decision-making	✓		✓		✓
Descriptive statistics	Situational Decision-making	✓	✓	✓	✓	
STEEPLE analysis	Situational	✓	✓	✓	✓	✓
SWOT analysis	Situational	✓	✓	✓	✓	✓
Contribution (HL only)	Decision-making		✓	✓	✓	✓
Critical path analysis (HL only)	Planning Decision-making	✓				✓
Force field analysis (HL only)	Situational Decision-making	✓	✓			✓
Gantt chart (HL only)	Planning	✓			✓	✓
Hofstede's cultural dimensions (HL only)	Situational	✓	✓		✓	✓
Linear regression (HL only)	Situational Decision-making	✓		✓	✓	✓
Porter's generic strategies (HL only)	Decision-making	✓		✓	✓	

Summary of the Business Management Toolkit (BMT)

1	SWOT analysis	Situational tool	SWOT analysis considers the strengths, weaknesses, opportunities and threats of a business at a specific point in time. Strengths and weaknesses are internal factors that influence the business, while opportunities and threats are external factors which the business has no direct control over.
2	Ansoff's matrix	Decision-making tool	The Ansoff matrix is a framework of generic growth strategies for a business, based on providing new or existing products in new or existing markets. These four generic growth strategies are categorised as (i) market penetration, (ii) market development, (iii) product development and (iv) diversification.
3	STEEPLE analysis	Situational tool	This framework considers factors in the external environment that affect a business. STEEPLE refers to the social, technological, economic, environmental, political, legal and ethical aspects of the external environment. It provides an overview of or insight into these external factors that are largely beyond the control of the organization.
4	Boston Consulting Group matrix	Situational tool Decision-making tool	The Boston Consulting Group (BCG) matrix allows managers to assess their organization's product portfolio based on measures of relative market share and market growth. It helps with long-term strategic planning and decision-making based on four categories of products: (i) question marks, (ii) stars, (iii) cash cows and (iv) dogs.
5	Business plan	Planning tool	This is an official guiding document that provides details of the organization's strategic goals and how the business intends to achieve these, with reference to the firm's human resources, finances, marketing and operations management. It is also commonly used to secure loans from financial lenders as well as raising finance from investors.

continued on following page...

Summary of the Business Management Toolkit (BMT)

	Tool	Category	Description
6	Decision trees	Decision-making tool	This tool is a graphical representation showing the probable outcomes of a business decision, based on the likelihood of success or failure of such a decision. The diagram shows the various choices faced by a business, including estimates of the costs and benefits in order to determine the probable risks of specific courses of action.
7	Descriptive statistics	Decision-making tool	This quantitative tool is used to summarise a given set of data to support statistical and data analysis. The various techniques help to present a large amount of quantitative data in a simplified and more manageable format. There are eight techniques specified for this tool: (i) Mean average, (ii) modal average, (iii) median average, (iv), bar charts, (v) pie charts, (vi) infographics, (vii) quartiles and (viii) standard deviation.
8	Circular business models	Decision-making tool	These models explore how businesses create value for their customers and other stakeholder groups whilst also reducing the environmental impacts of their operations. There are five circular business models specified in the syllabus: (i) circular supply models, (ii) resource recovery models, (iii) product life extension models, (iv) sharing models and (v) product service system models.
9	Gantt charts (HL only)	Planning tool	This visual tool helps managers to plan and schedule different tasks or jobs within a particular project. It illustrates the tasks or activities, their duration and dependencies in order to determine the shortest time required to complete the project and helps managers to schedule resources to complete each task and to keep the overall project on track to be completed on time.
10	Porter's generic strategies (HL only)	Decision-making tool	This commonly used tool helps managers to explore how a business can gain competitive advantages to help determine its strategic direction. These generic strategies comprise of: (i) cost leadership (producing at a lower cost than competitors), (ii) differentiation (providing products with a distinctive or unique selling point) and (iii) focus (selling specialized product aimed at specific market segments). Focus strategies are further categorised as (i) cost focus and (ii) differentiation focus.
11	Hofstede's cultural dimensions (HL only)	Situational tool	This tool helps managers to understanding the cultural similarities and differences that exist between and across different countries. This helps them to determine more appropriate ways to conduct their operations given different national and international settings. The tool suggests that countries can be categorised into one of six different cultural dimensions: (i) power distance, (ii) individualism vs collectivism, (iii) masculinity vs femininity, (iv) uncertainty avoidance, (v) long-term vs short-term orientation and (vi) indulgence vs restraint.
12	Force field analysis (HL only)	Situational tool Decision-making tool	This visual and quantitative tool is used by managers to examine the forces for and against change to make more-informed business decisions. It is useful during the planning and decision making stages of corporate strategy and change management. It provides an overview, in an easy to understand format, by illustrating and adding statistical weights to each of the driving and restraining forces identified in the analysis.
13	Critical path analysis (HL only)	Planning tool	This planning tool helps project managers to schedule and oversee large and complex projects to ensure efficient resource use and for the timely completion of the project. It maps out all the individual tasks or activities needed to complete the project so that realistic deadlines for a project can be set. The syllabus specifies HL students need to be able to: (i) complete and analyse a critical path diagram. (ii) identify the critical path from a diagram and (iii) calculate the free and total float from a CPA diagram.
14	Contribution (analysis) (HL only)	Decision-making tool	This quantitative tool is used to support business decision-making by enabling managers to analyse and evaluate different cost and revenue situations. This tool comprises of three techniques in the syllabus: (i) make or buy analysis, (ii) contribution costing and (iii) absorption costing.
15	Simple linear regression (HL only)	Decision-making tool	This quantitative tool comprises of three techniques used to identify, describe, and/or predict the relationship between dependent and independent variables under investigation. The three techniques covered in the course are: (i) scatter diagrams, (ii) line of best fit and (iii) correlation/extrapolation.

Chapter 44
Business Management Toolkit (BMT) 1 - SWOT Analysis)

"The greatest glory in living lies not in never failing, but in rising every time we fail."
- Nelson Mandela (1918 – 2013), President of South Africa 1994 to 1999*r*

SWOT analysis

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. SWOT analysis is a situation tool. Chapter references have been included as suggestions to show where SWOT analysis can be applied in various parts of the syllabus.

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Figure 44.1 - SWOT analysis is a commonly used situational tool

SWOT analysis is a situational tool used to assess the internal strengths and weaknesses and the external opportunities and threats of a business. SWOT is an acronym for **S**trengths, **W**eaknesses, **O**pportunities and **T**hreats. It can be used to assess the current situation of a business or organization. SWOT analysis considers both internal factors (strengths and weaknesses) and external factors (opportunities and threats) that are relevant to the organization under consideration.

- **Strengths** are internal factors that are favourable compared with competitors, such as strong brand loyalty, a good corporate image or highly skilled workers. Strengths help the business to better achieve its organizational objectives (see Chapter 3). Hence, strengths need to be developed and protected.

- **Weaknesses** are internal factors that are unfavourable when compared to rivals. Such factors create competitive disadvantages. Weaknesses are therefore likely to prevent or delay the business from achieving its goals. Hence, to remain competitive, the business needs to reduce or remove its weaknesses.

- **Opportunities** are the external possibilities (prospects) for future development. Such factors refer to changes in the external environment that create favourable conditions for a business. For example, India and China present many business opportunities for multinational companies (see Chapter 6), such as a huge customer base and rapid economic growth. Hence, SWOT analysis can help organizations to formulate their business strategies.

- **Threats** are the external factors that hinder the prospects for an organization. Hence, threats cause problems for the business. Examples include technological breakdowns, product defects and recalls (see Chapter 40), changes in fashion, price wars (Chapter 28), oil crises, recessions, natural disasters and the outbreak of infectious diseases.

Table 1.3.d SWOT analysis template (illustrative example)*

Strengths	Weaknesses
• Unique selling point • Brand awareness and brand loyalty • Experience, knowledge and skills • Market share / market dominance • Corporate image and brand reputation • Accreditation, endorsement or official support • Core competencies, e.g., product quality • Geographical location • Value for money (quality in relation to price)	• Limited revenue streams • Escalating costs of production • Poor cash flow / liquidity problems • Higher prices than closest rivals • Demotivated and/or unproductive workforce • Limited sources of finance • Lack of spare capacity • Restricted product range • Poor location
Opportunities	**Threats**
• Economic growth / upswing in the business cycle • Trade liberalization (government policies) • Weakening exchange rate • Technological developments • Advancements in infrastructure • Market growth • New markets and locations • Demographic and social lifestyle changes • Government spending programmes • Mergers and acquisitions of rival firms	• New entrants in the marketplace • Economic downturn (recession) • Inflation (causing higher production costs) • Pressure group action, e.g., protests • Social, environmental and legal constraints • Negative media coverage and publicity • Unfavourable changes in seasons and weather • Adverse changes in fashion and tastes • Crises, e.g. natural disasters or power shortages

* *Note:* what might be a strength for one business, such as its brand reputation or human capital, might actually be a weakness for another organization. Equally, some threats, such as a change in weather or climate, might also be considered as opportunities for other businesses.

CORE

Question 44.1 - Kidzplay Bouncy Castles

Kidzplay Bouncy Castles is a private limited company that operates in a niche market, catering for children's parties and events in London, UK. Outline whether each of the following scenarios represent a strength, weakness, opportunity or threat to Kidzplay Bouncy Castles.



(a) Limited competition in a niche market. *[2 marks]*

(b) Limited marketing on its new website *[2 marks]*

(c) Issues of recruiting and retaining staff. *[2 marks]*

(d) Demand in the winter months is low. *[2 marks]*

(e) Large profit margins could attract new competitors. *[2 marks]*

Exam tip !

When carrying out a SWOT analysis, remember that:

- Strengths and weaknesses are the *internal* factors that an organization *currently* faces.
- Opportunities and threats are the *external* factors that the organization is *likely* to face in the foreseeable future.

Developing business strategies based on SWOT analyses

SWOT analysis can be an extremely useful situational tool for investigating all sorts of business situations as part of strategic planning and decision making. For example, it can be used to provide a framework for:

- *Competitor analysis*, such as the threats posed by a competitor or the strengths of a rival.
- *Assessing opportunities*, such as the development and growth prospects for the organization.
- *Risk assessment*, such as the probable effects of investing in a certain project or location.
- *Reviewing corporate strategy,* such as the market position or strategic direction of the business.
- *Strategic planning*, such as the decision to diversify or expand in oversea markets.

Once a SWOT analysis is completed, appropriate business strategies can be identified and discussed to deal with potential situations in a more optimal way based on the organization's identified strengths, weaknesses, opportunities and threats. In particular, organizations should strive to:

- Build on their organizational strengths.
- Reverse their weaknesses.
- Maximize their responses to business opportunities.
- Overcome threats to their businesses.

Just investigating the strengths, weaknesses, opportunities and threats alone is of minimal value to managers and decision makers. From a SWOT analysis, four basic strategies can be identified.

	Opportunities	Threats
Strengths	*Offensive*	*Defensive*
Weaknesses	*Reorientation*	*Survival*

Figure 44.2 - SWOT analysis and business strategies

- *Offensive strategies* - The ideal situation occurs if a strength meets an opportunity as this enables the business to gain maximum benefit from a favourable external situation, i.e., the business should make the most of the favourable situation.
- *Defensive strategies* - In this case, a strength meets an external threat, so the situation presents an element of risk, which requires the business to defend itself. Typically, this strategy involves the business paying close attention to the competition so that it does not lose market share (see Chapter 23) or hinder its market dominance.
- *Reorientation strategies* - In this case, there is a favourable situation in the external environment, but which correlates to an internal weakness. Hence, the business needs to adjust or reorient its policies and practices. For example, this strategy could involve the business trying to cut costs to improve its liquidity position (see Chapter 18), remain competitive and gain market share.
- *Survival strategies* - The most undesirable situation occurs if a weakness meets an external threat. Survival policies are aimed at minimising the adverse effects of such a situation. This means that the business has to pay maximum attention to avoid a disastrous outcome and to survive.

Finally, it is important to remember that SWOT analysis does not guarantee that a strategy will be successful. For example, identifying weaknesses and threats does not necessarily mean that the business has sufficient financial and human resources to tackle these risks.

Exam tip !

When using a SWOT analysis in the exam, do *not* present the SWOT in tabular form. Using such a format can encourage you to squeeze your answers to fit inside a table that you have drawn. Examiners prefer written explanations and justifications. It is acceptable to write in bullet point format under each SWOT heading so long as the examiner can understand the *reasoning* behind your arguments.

Exam tip !

A common exam question will require you to examine the current position of a business by using a SWOT analysis framework. Therefore, be sure to learn how to use a SWOT analysis properly. Remember that the strengths and weaknesses refer to the *current* and *internal* position of the organization. The opportunities and threats should stem from a STEEPLE analysis of the external environment (see Chapter 46, Business Management Toolkit 3).

Evaluation of SWOT analysis

SWOT analysis is commonly used by businesses for its simplicity in strategic planning and decision making. As a situational tool, SWOT analysis encourages foresight and proactive thinking in the decision-making process rather than relying on the routine or intuitive reactions of managers and decision makers. Completing a SWOT analysis can be relatively quick and simple, allowing managers to organize their thinking and presenting their findings in a way that is easy to understand. It can help to determine the organization's position in the market (such as identifying the firm's core competencies) and therefore aids the development of appropriate business strategies for its long-term survival.

However, SWOT analysis can be overly simplistic and does not require a large amount of detail. The use of insufficient data often leads to poor business decision-making. There is also the potential for bias from managers in terms of what they choose to include or omit in the analysis. The analysis is only useful if decision makers are open about the weaknesses and threats and willing to act upon them, i.e., devoting time, people and finance to tackling weaknesses and threats. Furthermore, the model is static whereas the business environment in the real corporate world is always changing, so the usefulness of a SWOT analysis is limited.

SWOT analyses often lack quantitative assessment, with no value for the costs of addressing an identified weakness or potential rewards from pursuing an identified opportunity. Unlike some other tools, such as decision trees and force field analysis (see Chapters 49 and 55 respectively), the use of SWOT analysis does not prioritise issues for managers and decision makers.

Typically, SWOT analysis cannot be used in isolation. After all, a SWOT analysis only assesses the current situation and does not suggest any actual strategy. Better decisions are made if more information is available, so other tools may be required to achieve this. Nevertheless, as it encourages managers to think holistically and collaboratively, SWOT analysis can help to reduce the overall risks of decision-making by demanding objective, more informed and logical thought processes.

REVIEW QUESTIONS

1. What is a SWOT analysis?
2. Why might businesses choose to use a SWOT analysis?
3. How might SWOT analysis help managers to reduce the risks involved in decision-making?
4. What are the strategic options that businesses have after the completion of a SWOT analysis?
5. What are the limitations of using SWOT analysis as a situational tool?

KEY TERMS

Opportunities are the external possibilities (prospects) for future development.

Strengths are internal factors that are favourable compared with competitors.

SWOT analysis is a situational tool used to assess the internal strengths and weaknesses and the external opportunities and threats of a business.

Threats are the external factors that hinder the prospects for an organization.

Weaknesses are internal factors that are unfavourable when compared to rivals.

Chapter 45
Business Management Toolkit (BMT) 2 - The Ansoff matrix

"One can choose to go back toward safety or forward toward growth. Growth must be chosen again and again; fear must be overcome again and again."
- Abraham Maslow (1908 – 1970), American psychologist

The Ansoff matrix

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. The Ansoff matrix is a decision-making tool. Chapter references have been included as suggestions to show where the Ansoff matrix can be applied in various parts of the syllabus.

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The **Ansoff matrix** (1957) is an analytical tool that helps managers to choose and devise various product and market growth strategies. Professor Igor Ansoff (1918 - 2002) showed the different growth strategies that a firm can take depending on whether it wants to sell new or existing products in either new or existing markets (see Figure 45.1). The four product-market growth strategies or growth options, in this model are explained below.

		Products	
		Existing	New
Markets	Existing	*Market penetration*	*Product development*
	New	*Market development*	*Diversification*

Figure 45.1 - The Ansoff Matrix

(i) Market penetration

Market penetration is the growth strategy that involves a business choosing to focus on ***selling existing products in existing markets***, i.e., to increase their market share of current products. Hence, this is a relatively low-risk growth strategy. Market penetration might be achieved by offering more competitive prices (see Chapter 28) or by improved advertising (see Chapter 29) to enhance the desirability of the product. In addition to attracting more customers, firms might attempt to entice existing customers to buy more frequently, perhaps by offering customer loyalty schemes (see Chapter 43). Brands might also be repositioned (see Chapter 24) to achieve market penetration.

An advantage of market penetration is that the business focuses on markets and products that it is familiar with. Hence, market research expenditure (see Chapter 26) can be minimised. It is also the safest of the four growth strategies.

A limitation of market penetration is that competitors, especially stronger rivals, are likely to retaliate to any business trying to take away their customers and market share. This can lead to aggressive reactions, such as price wars (see Chapter 28), thereby harming profits in the short term at least. Also, once existing markets become saturated, alternative growth strategies are required if the business is to continue its growth and evolution.

(ii) Product development

Product development is a growth strategy that involves ***selling new products in existing markets***. Hence, this strategy carries a medium level of risk for the business. Apple's launch of the iPhone in 2007 revolutionised the mobile phone industry and propelled the profits for the computer manufacturer founded in 1976. McDonald's often adds new products to its menu. Car manufacturers introduce new models and occasionally limited editions of their cars. These are all examples of product development growth strategies.



Figure 45.2 - McDonald's product development strategy involves new additions to its menu

Product development tends to rely heavily on **product extension strategies** to prolong the demand for goods and services that have reached the saturation or decline stage of their product life cycle (see Chapter 27). Product development is also reliant on brand development to appeal to the existing market. For example, well-established companies such as Sony or Nike can use their brand names to launch new products to the market as there are fewer risks of introducing a new product under a well-known and trusted brand.

Product development is also a reason for mergers and acquisitions with other companies (see Chapter 5). For example, Tata Motor's acquisition of Jaguar Land Rover in 2008 meant it could cater for different types of customers without the huge costs and risks of starting a new company.

Case study 45.1 - Tata Motors

Tata Motors was founded in 1945 and has become India's largest automaker, with a product range that includes cars and sports utility vehicles, commercial vans, trucks, buses, coaches and military vehicles. In 2004, it acquired South Korean truck manufacturer Daewoo Commercial Vehicles Company. In 2008, it purchased UK luxury brands Jaguar and Land Rover. It also produced the Tata Nano, once the world's cheapest mass-produced car.

(iii) Market development

Market development is the growth strategy that involves ***selling existing products in new markets***, i.e., an established product is marketed to a new set of customers. This might be done through new distribution channels such as selling the existing product overseas (although this could be quite risky if the business is unfamiliar with local market conditions and cultures). Alternatively, promotional strategies could be tweaked to make the product more appealing to the new audience. Pricing methods (see Chapter 28) could also be changed to attract different market segments.

A key advantage of this growth strategy is that the business is familiar with the product that is being marketed. For example, Nike and Adidas successfully market their clothing products for leisure rather than specifically for sports. Nokia uses market development to sell its excess supply of mass-produced smartphones that have a short product life cycle in more economically developed countries (where customers frequently upgrade their devices) by selling these in lower income countries such as Sri Lanka, Indonesia and Nigeria.

However, the success of a product in one market does not necessarily guarantee its success in other markets. Market development is a medium risk growth strategy as it involves the business competing in new markets. For example, French retailing giant Carrefour pulled out of Thailand, Malaysia and Singapore in late 2010 after failing to establish a market presence. American retail giant Target closed more than 130 stores in Canada in 2015 for similar reasons, citing cultural differences (see Chapter 11). Google struggled to establish itself in China, where local company Baidu maintains around 85% market share.

(iv) Diversification

Diversification is a high-risk growth strategy that involves ***selling new products in new markets.*** For example, the Virgin Group is a diversified company with its various strategic business units (see Case Study below). In addition to capturing market share in established markets, a key driving force for diversification is to spread risks by having a well-balanced product portfolio (see Chapter 27). Diversification is also suitable for businesses that have reached saturation and are seeking new opportunities for growth.

One way to diversify is to become a **holding company**. This is a business that owns (or holds) a controlling interest in other diverse companies. This means the holding company owns enough shares in other businesses to be able to take control.

Holding companies (or **parent companies**) can benefit from having a presence in a variety of industries in different regions of the world. An example is Warner Media, the parent company of numerous **subsidiaries** (firms owned by a holding company) including Warner Bros, Cinemax, DC Comics, CNN, HBO and Cartoon Network.

Case study 45.2 - Virgin Group

Virgin Group Ltd. is a UK multinational conglomerate, co-founded by Sir Richard Branson and Nik Powell in 1970. The company is a truly diversified business, with operations in industries as diverse as healthcare, travel, media, entertainment, hospitality, retail, telecommunications, banking, motorsport, cruise line, charity and even aerospace.

There are two categories of diversification.

1. **Related diversification** occurs when a business caters for new customers within the broader confines of the same industry. For example, many large commercial banks also offer services in wealth management and insurance. Japanese car makers Toyota, Nissan and Honda have strategic business units (Lexus, Infiniti and Acura, respectively) that cater for higher income customers. Related diversification is less risky as it builds on the product and market knowledge of the business.

2. By contrast, **unrelated diversification** refers to growth by selling completely new products in untapped markets. For example, Honda also produces lawnmowers and airplanes. Another example is Samsung, with operations in consumer electronics, shipbuilding, construction, retail, chemicals and insurance.

Nevertheless, diversification remains the riskiest of the four growth options in Ansoff's matrix as the business is not operating in familiar territory when launching new products in markets it has little, if any, experience of. For example, Harley Davidson, renowned for its motorcycles, diversified into the fragrance industry in the 1990s which caused much offense to its loyal customer base. Next, the UK clothing retailer, failed to establish itself in the tablet computers market in 2010. The Virgin Group tried to take on Coca-Cola and Pepsi by launching Virgin Cola, but only managed to capture a market share of 3% in the UK.



Figure 45.3 - Honda makes more than just cars

Furthermore, new distribution channels (see Chapter 30) need to be established and this can be time consuming and costly. Such distractions can also mean an organization loses focus of its core business with serious consequences.

ATL Activity 45.1 (Thinking skills)

Discuss how knowledge of the Ansoff matrix might help businesses that plan to expand in overseas markets. You might find reviewing the contents of Chapter 6 useful prior to addressing this task.

Table 45.1 - Summary of the Ansoff matrix

Market penetration	Product development	Market development	Diversification
Same products for existing customers	New products for existing customers	New customers for existing products	New products for new customers
Minimal risk	Moderate risk	Moderate risk	High risk
Seek to maintain or raise market share	Innovation to replace existing products	Entering overseas markets	Spreading of risks
Intense competition	Product improvements	New distribution channels	Use of subsidiaries and strategic business units

Question 45.1 - Growth strategies

Use the Ansoff Matrix to explain the growth strategies in the following cases:

(a) Cadbury, the chocolate manufacturer, launches new products under the names of *Crème Eggs, Flake, Crunchie* and *Heroes* to compete with existing rival brands. *[4 marks]*

(b) Toyota, the world's largest car manufacturer, launches a new line of upmarket cars under the *Lexus* brand to cater for wealthier customers. *[4 marks]*

(c) Tesco, one of the world's largest supermarket chains, expands by providing petrol and financial services to its customers. *[4 marks]*

(d) McDonald's introduces wedding services under the *McWedding* brand name. *[4 marks]*

Evaluation of Ansoff's matrix

The Ansoff matrix is a decision-making tool that provides a simple way for managers and entrepreneurs to compartmentalise various growth strategies based on a business providing existing or new products in new or existing markets. The tool prompts discussions about the potential risks and rewards of each potential growth strategy.

However, the tool does not quantify these risks and rewards (unlike decision trees, for example) nor does it actually suggest a particular strategy that the business should pursue (unlike forcefield analysis, for example).

Instead, any managerial preference that stems from using the Ansoff matrix needs further research and data. For example, a market development strategy is likely to require decision makers to investigate the challenges of entering new markets, especially those in overseas locations. Decision makers are also likely to conduct a competitor analysis to determine the probable reactions of existing firms in the market. This also applies to a diversification growth strategy as it carries even more risk. This means the Ansoff Matrix may be used alongside other Business Management tools, such as SWOT and STEEPLE analyses (see Chapters 44 and 46 respectively), in order to gain a more complete picture and to make better-informed decisions.

In reality, firms are not limited to a single growth strategy. Large multinational companies competing in highly contestable markets need to use multiple business strategies to grow, evolve and remain competitive.

CORE

Question 45.2 - Adidas

According to its corporate website, Adidas strives "*to be the best sports brand in the world.*" This mission statement is supported by the company's growth strategy of **market development** across the world, in its attempt to be the global leader in the sporting goods industry with brands built on a passion for sports and a sporting lifestyle.

The COVID-19 pandemic caused sales revenues at Adidas to fall by 16% in 2020 to €19.84bn ($22.44bn). This caused the company to change its growth strategy to develop **new distribution channels**, with a shift from selling its goods in retail outlets to using e-commerce and mail order. The company's growth strategy includes plans to double its e-commerce business to €9bn ($10.2bn) by 2025.

Source: https://www.adidas-group.com/en/about/profile/

(a) Define the term *market development.* *[2 marks]*

(b) Define the term *distribution channels.* *[2 marks]*

(c) Explain **one** advantage and **one** disadvantage of Adidas's market development strategy. *[4 marks]*

REVIEW QUESTIONS

1. What is the Ansoff matrix?
2. Why is market penetration a relatively low-risk growth strategy?
3. Why is product development a medium-risk growth strategy?
4. Why is market development also a medium-risk growth strategy?
5. What makes diversification the highest risk growth strategy in Ansoff's matrix?

KEY TERMS

The **Ansoff matrix** (1957) is a decision-making tool used to devise various product and market growth strategies, depending on whether businesses want to market new or existing products in either new or existing markets.

Diversification is a growth strategy in the Ansoff matrix, which involves an organization launching new products in new markets.

A **holding company** (or **parent company**) is a diversified business that owns a controlling interest in other diverse companies.

Market development is a growth strategy in the Ansoff matrix that focuses on using customer loyalty to persuade current and prospective customers to purchase a new product from the business.

Market penetration is a growth strategy in the Ansoff matrix that focuses on developing existing markets with existing products, in order to increase the firm's sales revenue and market share.

Product development is a growth strategy in the Ansoff matrix that involves introducing new products to existing customers by developing or replacing current products.

Chapter 46
Business Management Toolkit (BMT) 3 - STEEPLE analysis

"The reasonable man adapts himself to the world; the unreasonable one persists in trying to adapt the world to himself."
- George Bernard Shaw (1856 - 1950), Irish author

STEEPLE analysis

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. STEEPLE analysis is a situation tool.

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STEEPLE is an acronym for the **S**ocial, **T**echnological, **E**conomic, **E**nvironmental, **P**olitical, **L**egal and **E**thical opportunities and threats in the external business environment. These factors, unlike internal ones, affect all businesses yet are beyond the control of any individual organization. STEEPLE analysis is a situation tool that is central to formulating business strategy, such as assessing the feasibility of an overseas investment project.

External factors that represent prospects for businesses are called **opportunities,** such as lower tax rates and lower interest rates. External factors that can harm a business are called **threats,** such as a recession, oil crisis or major road works.



Figure 46.1 - Roadworks are a major external constraint on local businesses

A simplified example of a STEEPLE analysis is shown in the worked example on the following page, which explores some of the opportunities and threats of multinational companies operating in India.

Worked example - STEEPLE analysis of multinational companies operating in India

Social factors

- Potential market of over 1.38 billion people (the second most populous country in the world)
- A large and well-educated English-speaking workforce of around 130 million people.
- Large yet increasing discrepancies in the distribution of income and wealth.
- Language barriers in rural cities, with potential clash of national cultures in a multilingual and multi-ethnic country.

Technological factors

- Growing number of technologically aware population (huge opportunities for firms providing products such as mobile phones, personal computers, and Internet services). Bengaluru, the IT capital of India, is widely regarded as the "Silicon Valley of India".
- Major industries include communications technology, biotechnology, computer software, automobiles, petrochemicals, and pharmaceuticals.
- Technologies are easily copied due to a lack of appropriate legislation.

Economic factors

- Huge growth potential in financial markets.
- Significant economic growth and rising disposable incomes (spending power) in India.
- Improved infrastructure and market opportunities in cities such as Mumbai, Bengaluru, and New Delhi.
- Relatively low costs of production (average wage rates are still very low).
- Most people are employed in the agricultural sector, with India being one of the world's top producers of cereals (wheat, rice and sugar), meat, fruits, vegetables, tea, coffee, cotton, coal and wool.
- Infrastructure and economic stability are less attractive than in other countries such as China and the United Arab Emirates.
- The vast majority of the Indian population is still very poor, with a real GDP per capital of less than $2,000 in 2022.

Environmental factors

- Major challenges for India include tackling air pollution, water pollution, littering, waste disposal and environmental degradation.
- The Indian government is taking a more proactive approach to enforcing environmental protection.

Political factors

- Political reform in India will encourage better trade relations with other nations.
- Legislation is less stringent than in other nations, thus placing fewer constraints on business activity.
- Regarded as less politically stable and relatively corrupt compared with other countries in the region.
- Poor enforcement of patents and copyrights might discourage technology transfer to India.

Legal factors

- • Strict compliance laws for foreign bank accounts and heavy penalties for tax evasion.
- Employment legislation is often overlooked, such as poaching of staff from competitors is commonplace.
- There are no specific data protection laws enforced in India.

Ethical factors

- Corruption is widespread, which does little to help combat poverty and can harm India's international competitiveness.
- Slow business negotiations because establishing a trusting relationship is a prerequisite to doing business in India.
- Indian culture is averse to critical disagreements, such as saying 'no', as this is seen as being rather rude; disagreements should be expressed in an ethical way, using diplomatic language.
- It can be difficult for foreign businesses to penetrate the Indian economy without partnering with a local Indian company.

The importance of each opportunity and threat identified in a STEEPLE analysis can be weighted in a scientific or objective way. This is useful when trying to examine the advantages and disadvantages of a decision. If the overall importance placed on the opportunities of a decision outweigh the threats, then the business is likely to pursue that option. However, in reality, external factors are subject to rapid and unforeseeable change. An external shock, such as a global pandemic or a financial crisis, can jeopardize the chances of success despite what a STEEPLE analysis initially revealed.

A key advantage of STEEPLE analysis is that it is relatively simple to use. The analysis helps managers to be thorough and logical in their analysis of the external opportunities and threats faced by the business. It is also a useful situational tool for brainstorming and discussions. STEEPLE analysis promotes proactive and forward thinking, rather than static views based on gut feelings. Hence, it is more likely that managers will be better informed and prepared to deal with changes in the external environment.

Exam tip !

It is not always necessary to conduct a full STEEPLE analysis. In the real corporate world, managers may prefer to use a **PEST analysis**, where *political factors* include (where appropriate) legal opportunities and threats, and *social factors* include ethical and environmental opportunities and threats.



Figure 46.2 - The STEEPLE analysis framework

Social opportunities and threats (STEEPLE analysis)

Social factors in a STEEPLE analysis can directly affect the activities of a business. The values and attitudes of society towards a wide range of different issues (such as business ethics, social welfare, women, religion or animal rights) can present both opportunities and threats for businesses. Social factors include consideration of cultural and demographic opportunities and threats. Examples include the following:

- The growing public support for environmental protection has altered business behaviour, with many organizations now reporting non-financial aspects of their operations, such as recycling and waste management.
- With a more liberal and modern social attitude towards women in most societies, businesses have benefited from having a more flexible labour force.

CORE

Question 46.1 - Internal and external constraints

Examine the internal and external constraints for any **one** of the following business decisions.

(i) Kraft Foods announces a takeover bid for Cadbury.

(ii) Singapore Airlines plans to move its call centre to India.

(iii) The Walt Disney Company opens a new theme park in Shanghai.

(iv) Virgin Atlantic unveils plans to start daily flights to Nairobi, Kenya. *[6 marks]*

- Migration and the increased awareness and acceptance of multiculturalism has created more choice for consumers. For example, the most consumed take-out food in the UK is Indian curry, whilst the largest non-Asian importer of Malaysian Laksa (spicy noodle soup) is Finland.

- Societal pressures for businesses to act more ethically and socially responsibly can often result in higher costs.

- Demographic changes in society, such as an ageing population in high-income countries, have affected recruitment practices, marketing strategies and the products supplied by businesses. More women in modern societies are opting to have children at a later age as they choose to give their careers priority, thereby providing further opportunities for businesses.

- Language can create opportunities and threats too. The largest multinational companies are aware that the most commonly spoken languages around the world are Mandarin, English, Spanish and Hindi. However, it is not always possible to translate marketing messages and other communications across different languages and cultures (see Chapter 34).



Figure 46.3 - Language barriers can cause cultural misunderstandings

Case study 46.1 - Marks & Spencer

The dynamics of social factors can create challenges for businesses. For example, in December 2013, Marks & Spencer announced that its Muslim employees would not have to sell pork or alcohol to customers. By contrast, supermarket chains Tesco and Sainsbury's said it made no business sense to hire checkout staff who refused to touch or serve certain items due to religious reasons.

Theory of Knowledge (TOK)

How do the words we use in different societies to describe 'equal opportunities' affect our understanding of the concept? Are there other meanings and does it matter which interpretation we use?

Theory of Knowledge (TOK)

Archbishop Desmond Tutu (1931-2021), South African human rights activist and recipient of the Nobel Peace Prize (1984), said that "*If we are going to see real development in the world then our best investment is women.*"

In the context of Business Management, discuss the extent to which you agree or disagree with this statement.

CORE

Business Management Toolkit (BMT)

Question 46.2 - Demographic changes

Comment on how the following demographic changes present both opportunities and threats to businesses.

(a) A growing number of self-employed people. *[4 marks]*

(b) An increasing number of single-parent families. *[4 marks]*

(c) Adults choosing to have fewer children and at a later stage in their lives. *[4 marks]*

(d) An increasing number of people graduate with university degrees. *[4 marks]*

Technological opportunities and threats (STEEPLE analysis)

The technological environment refers to scientific knowledge and application to the external environment that presents constant threats and opportunities. Advances in technology and work processes have improved productivity. For example, Internet technologies (see Table 46.1) create countless opportunities for entrepreneurs to set up and run their businesses without some of the financial risks of establishing a physical business. Success stories include Mark Zuckerberg (Facebook), Kevin Systrom (Instagram), Reed Hastings and Marc Randolph (Netflix), Zhang Yiming (Tik Tok) and Eric Yuan (Zoom).

However, the high cost of staying up to date with technological progress can cause problems for businesses. For example, Airbus faced lengthy delays in the production of the A380 (the world's largest commercial aircraft) and subsequently had to compensate its customers such as Emirates Airlines and Singapore Airlines.

Technology affects all aspects of business functions. For instance, the Internet has directly affected Human Resource Management (in the recruitment process), Marketing (such as e-commerce), Finance (annual reports are published online) and Operations Management (such as access to benchmarking data).

Apart from the Internet, other opportunities that technology can bring to businesses include:

- *New working practices* - Many more businesses are using flexible working practices (see Chapter 7), such as enabling people to work from home, by using Information Communication Technology (ICT). Global businesses are also increasingly using video conferencing to cut the costs of face-to-face meetings and international recruitment. Marketing activities have also been affected, such as the growing popularity of online advertising.

- *Increased productivity and efficiency gains* - Robots and machines are much faster yet more accurate than humans, especially in the mass production of products over prolonged periods of time. Unlike humans, machinery can be made to work for very long hours without the need for breaks, financial rewards, motivation or maternity leave! Firms are also more likely to achieve zero defects (no wastage) from the use of technology (see Chapter 40). Automated stock control systems can automatically re-order stocks. Despite the large initial costs of automation and technology, capital-intensive firms can benefit from cost savings in the long run.

- *Quicker product development times* - The use of CAD/CAM technology (computer aided design and computer aided manufacturing) has allowed firms to produce prototypes in a timely and cost-effective way, thereby accelerating the design, manufacturing and launch of new products.

Table 46.1 - Opportunities and threats of internet technologies

Opportunities	Threats
Speed of access to information - Businesses and customers can gain access to up-to-date information from any part of the world through dedicated websites, such as the huge range of online news media sources that give invaluable information to users in a cost-effective way.	*Price transparency* - Firms are exposed to the forces of competition as customers can easily compare the prices of different businesses without leaving their home or office. In addition, as there is no physical presence, it can be difficult to judge a product's quality relative to the price.
Reducing language and cultural barriers - Information on the Internet can be easily translated into different languages by using dedicated software or translators. This can also help to reduce the costs of trading overseas.	*Online crime* - Hackers have cost e-commerce businesses a huge amount of money. Online banking scams and credit card fraud are quite common. This threat has therefore restricted the number of online customers.
Reduced costs - Firms with an online presence can benefit immensely from e-commerce. Trading can take place at any time from any part of the world without the need for a physical outlet. Therefore, labour costs can also be reduced.	*Higher production costs* - In addition to the costs of online crime, businesses also face maintenance and training costs to ensure that employees are competent and confident in their use of the latest Internet and online technologies.
Overcoming geographical limitations - The Internet makes location less of an issue for many businesses. The increasing use of mobile devices has fuelled e-commerce and literally eliminated any limitations of geographical proximity to physical retailers.	*Reduced productivity* - Surveys from around the world have consistently shown that labour productivity is harmed by employees who regularly access personal emails and social media websites during working hours.

- *Job creation* - Advances in technology bring about a need for maintenance and technical support staff. Examples include programmers, hardware and software engineers, graphic designers and ICT teachers/instructors.

- *New products and new markets* - Technology is a source of innovation and brings about new products in the marketplace, such as wireless broadband services, smartphones, high-definition 3D smart televisions, social media platforms and electric vehicles. Apple's highly successful range of innovative products elevated the company to become one of the most valuable businesses on the planet.



Figure 46.4 - Electric cars are becoming increasingly popular around the world

The technological environment also presents certain threats to businesses, such as:

- *Technology is not always reliable or secure* - Computer failure or hacked files can present serious problems for businesses. For example, in December 2013, over 40 million credit and debit card records were hacked from US retailer Target. In 2018, Facebook was in trouble with the law due to a massive data scandal, with allegations of misuse of personal data to influence the 2016 US presidential elections and the Brexit vote (the UK leaving the European Union).

- *Shorter product life cycles* (see Chapter 27) - Equipment and software may become obsolete increasingly quicker and therefore need to be upgraded regularly. This can make it gradually more difficult for smaller firms to compete.

- *It can be costly* - As products such as smartphones, flat screen televisions and other electronic appliances have shorter life cycles, businesses need to devote more resources to new product development.

- *Job losses* - Automation has led to unemployment in the primary and secondary sectors, such as commercial farming, oil extraction and car manufacturing. In the tertiary sector, many supermarket checkout assistants have been replaced with self-service checkout machines. Therefore, businesses need to carefully manage the process of staff redundancies (job losses).

Case study 46.2 - Tesco

In June 2010, Tesco opened the UK's first supermarket without any checkout staff. Instead, one person is hired at the store in Northampton to supervise the five checkouts, mainly to assist customers who have not used a self-service checkout before. Tesco, the UK's largest retailer with over 28% market share in the groceries industry, employs over 423,000 but critics argue that such technologies would cause mass job losses. Today, self-checkout tills are commonplace in retailing sector.

When adopting certain technologies, managers need to consider several factors:

- *Costs* - such as the cost of purchase, installation, maintenance, depreciation, replacement (upgrading) and insurance of the new technologies.

- *Benefits* - such as the expected gains in efficiency (as measured by improvements in productivity, flexibility and communications) and profits.

- *Human relations* - such as the impact of resistance to change and the impacts on morale, flexible working patterns and workforce planning (see Chapter 7).

- *Recruitment and training* - such as the costs of training workers (see Chapter 7) to adopt the new technologies, the number of people who need training and where to find the time to train people.

Question 46.3 - Nintendo

The Nintendo Wii was a huge hit with customers. Launched in 2006, Nintendo's games console appealed to new **market segments** including women and the elderly. Demand was particularly high in Asia, Europe and the USA, helping Nintendo to sell its 100 millionth console by the end of 2013. Its most popular game, *Wii Sports*, has sold over 83 million copies worldwide by 2021. The Wii was replaced by the Wii U in November 2012 (the Xbox One and PlayStation 4 were not released until November 2013). According to Nintendo, the company sold 425,000 unit of its Wii U in the first month of sale in the USA alone. The Wii U was replaced in 2017 with Nintendo's Switch. Today, the Nintendo Switch is the world's best-selling games consoles, outselling Sony's PlayStation and Microsoft's Xbox.

(a) Define the term *market segments*. *[2 marks]*

(b) Explain how the technological environment can present opportunities for hi-tech firms such as Nintendo. *[6 marks]*

Economic opportunities and threats (STEEPLE analysis)

The economic environment refers to the state of the economy in which businesses operate. This is determined by the government's ability to achieve its key economic objectives: (i) to control inflation, (ii) to reduce unemployment, (iii) to achieve economic growth and (iv) to achieve a healthy international trade balance. Government policies used to achieve these fundamental goals will therefore present opportunities and threats for businesses.

(i) To control inflation

Inflation is the continual rise in the general level of prices in an economy. Most economists regard low and stable inflation as a prerequisite to achieving the other three key economic objectives, so this is an absolute priority for economic prosperity. Inflation, if not controlled, can complicate business planning and decision-making. For example, raw material costs, catalogue and menu prices and wage claims are all affected by inflation. Essentially, inflation that is not controlled becomes a threat to businesses due to the higher costs and the uncertainties that are caused.

Question 46.4 - Zimbabwe's hyperinflation problems

Zimbabwe suffered immensely from the impacts of hyperinflation for almost a decade, with annual rates reaching 231,000,000% in July 2008. This meant that prices of goods and services in the country in Southeast Africa were more than doubling each week! Back in June 2006, the country's Reserve Bank had issued a new bank denomination - the 100,000 Zimbabwean dollar note (less than $1 at the time).



However, by January 2009 the government had launched the 100 trillion Zimbabwean dollar banknote (ZWD100,000,000,000,000)! The Zimbabwean dollar was eventually abandoned in favour of the US dollar as the nation's official currency. Economists warned that the problem would continue to be a major issue unless the government dealt with the root causes of **inflation**. According to the World Bank, around 4.8 million Zimbabweans (around 34% of the population) live below the international poverty line of US$1.90 per day.

(a) Define the term *inflation*. *[2 marks]*

(b) State **two** factors that could have caused inflation in Zimbabwe. *[2 marks]*

(c) Examine the impact of uncontrollable inflation for businesses in Zimbabwe. *[6 marks]*

Inflation also affects the international competitiveness of a country (see Question 46.4). An economy that has a relatively higher inflation rate tends to be less price-competitive when trading overseas. This would generally lead to a fall in export earnings, lower national output and higher unemployment. Hence, uncontrolled inflation is detrimental to businesses operating in the domestic economy.

Inflation can be caused by excessive demand in the economy (too much spending). Any factor that causes a rise in consumption, investment, government spending or international trade earnings will increase the economy's aggregate demand. For example, households and firms will spend more money and at a faster rate if income levels continually rise, thereby fuelling inflation. Alternatively, inflation can be caused by higher costs of production (leading to a rise in prices so that firms can maintain their profit margins). Examples include increased wages caused by trade union action, soaring prices caused by an energy crisis and higher rents in the economy.

(ii) To reduce unemployment

The **unemployment rate** measures the proportion of a country's workforce not in official employment. Governments aim to deal with the problems of unemployment because there are social costs of high unemployment (which present further threats to businesses). For example, the local community might suffer from widespread poverty and increased crime levels. There is an increased burden on taxpayers to support government spending on welfare benefits for the unemployed, which means taxpayers have less disposable income to spend on goods and services. Overall, the country's international competitiveness is therefore likely to deteriorate.

Box 46.1 - Types of Unemployment

- *Frictional unemployment* occurs when people change jobs as there is usually a time lag between leaving a job and finding or starting another.
- *Technological unemployment* results from the introduction of labour-saving (capital-intensive) technologies, which can cause mass-scale unemployment.
- *Seasonal unemployment* is caused by periodic and reoccurring changes in demand for a product. For example, beach resorts tend to suffer from a lack of tourists during the winter months.
- *Cyclical unemployment* (or *demand deficient unemployment*) is caused by a lack of demand in the economy. It is the most severe type of unemployment, as it occurs during an economic recession so tends to affect all industries.



Employment in the Maldives relies heavily on leisure and tourism

Case study 46.3 - Unemployment and the COVID-19 pandemic

The coronavirus outbreak of 2019 (and beyond) caused the world's deepest recession in living memory, with business closures and job losses in literally every industry in every country in the world. For example, the US recorded a historical high of more than 44 million people registered as unemployed. Data from the Australian Bureau of Statistics (ABS) showed that Australia went into a recession for the first time in 3 decades, caused by retail spending in the country falling by $5.38 billion between March and April 2021, creating mass unemployment across the economy. According to Business Insider India, more than half of all coronavirus-related business closures since March 2020 are now permanent.

Theory of Knowledge (TOK)

To what extent should governments be morally obliged to provide free education and healthcare to all its people, funded by taxpayers' money?

CORE

Business Management Toolkit (BMT)

(iii) To achieve economic growth

Economic growth is the increase in the value of a country's economic activity over time. It is measured by the change in the economy's **gross domestic product** (GDP) per year. Higher rates of economic growth suggest that the economy is more prosperous and therefore the average person earns more income, creating more opportunities for businesses. The pattern of fluctuations in economic growth is known as the **business cycle** (see Figure 46.5).

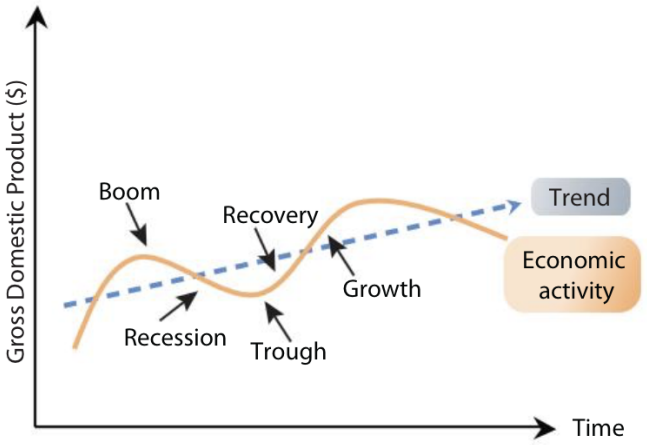

Figure 46.5 - The business cycle

- During a **boom,** the level of economic activity rises, with consumer expenditure, investment spending and export earnings all increasing. At the peak, economic activity is at its highest level, so unemployment is low whilst consumer and business confidence levels are high, resulting in higher levels of sales and profit for businesses.

- A **recession** occurs when there is a fall in GDP for two consecutive quarters (6 months). It is caused by a continual decline in spending in the economy, lower investments, falling export earnings and rising unemployment. Businesses that are most likely to suffer are those that have a small product range and sell products that are sensitive to changes in incomes (such as real estate, cars, jewellery and overseas holidays). Box 46.2 outlines ways that businesses can deal with the threats of a recession.

- A **trough** (or **slump**) refers to the bottom of a recession and the last stage of decline in the business cycle, with high unemployment alongside very low levels of consumer spending, investment and export earnings. Businesses suffer from poor cash flow (see Chapter 20) and many will have already closed down due to poor liquidity (insufficient money to run the business). Consumers have little confidence in the economy and workers suffer from a lack of job security.

- **Recovery** occurs when the level of GDP starts to rise again, after the economy has experienced a slump. Since national output and income begin to increase again, the level of consumption, investment, exports and employment will all gradually rise, creating opportunities for businesses.

Box 46.2 - Coping with a recession

- *Cost reductions* to improve cash flow, such as efforts to cut energy bills, finding alternative suppliers who can offer better prices, relocating to cheaper premises or making some staff redundant.

- *Price reductions* to sustain or increase sales. People become more price sensitive during a recession, so lower prices will be appreciated by potential customers.

- *Non-pricing strategies* (such as repackaging, special offers or other promotional strategies) to sustain or revitalise the volume of sales.

- *Branding strategies* to maintain sales because customers become or remain loyal to a brand irrespective of changes in price or their incomes.

- *Outsourcing production overseas* where costs are lower to help the business to gain a competitive price advantage, thereby reducing the impact of a recession in the domestic economy.

Low-income countries have found it difficult to achieve economic growth. Barriers to growth exist, such as a lack of infrastructure (transport and communications networks). These constraints become a restraining force for many businesses that wish to expand overseas. Businesses operating in countries without basic electricity, road networks, schools, hospitals and housing find it relatively difficult to achieve economic growth and prosperity.



Figure 46.6 - Low-income communities lack infrastructure needed for growth

Theory of Knowledge (TOK)

Is economic growth always desirable? What does 'desirable' actually mean? To whom?

(iv) To achieve a healthy international trade balance

In broad terms, the internal trade balance records the value of a country's export earnings and its import expenditure. Governments strive to avoid a deficit on their international trade balance. This means they try to avoid the value of import expenditure exceeding export earnings. Just as individuals cannot spend more than they earn in the long run, the same applies to countries.

To correct an imbalance on its international trade balance, governments often attempt to alter their **exchange rate**, which can provide opportunities or threats for businesses. The exchange rate measures the value of the domestic currency in terms of foreign currencies. A higher exchange rate (known as an appreciation of the currency) means that export prices will be relatively higher, thereby reducing the exporter's price competitiveness. Although a lower exchange rate (known as a depreciation of the currency) should give domestic firms a relative price advantage, it also means that they have to pay higher prices for imported raw materials and components.

Continual and large fluctuations in exchange rates can create threats for businesses. Business planning and forecasting become very complex and perhaps impractical. For example, businesses may not be able to accurately forecast export sales or costs of imported materials due to exchange rate volatility. International trade deals could be postponed until the business can benefit from more favourable movements in the exchange rate (although there is no guarantee that this will ever happen).



Figure 46.7 - Fluctuations in the exchange rate affect business operations and profitability

Alternatively, governments can set up international trade barriers to correct any disparity in its international trade balance or to protect their domestic industries. **Protectionist measures** refer to any government policy used to safeguard domestic businesses from foreign competitors (see Box 46.3). Such measures present threats or barriers to trade, for foreign businesses operating in overseas markets.

Box 46.3 - Examples of protectionist measures

- Tariffs (or customs duties) are taxes on imported products, thereby raising their price to give domestic firms a price advantage.
- Quotas are quantitative limits on the volume or value of imports, thereby protecting their domestic industries.
- Subsidies are payments made by a government to domestic businesses as a form of financial aid to reduce their production costs, thereby giving domestic firms a competitive advantage.
- Embargos are physical bans on international trade with a certain country, usually due to strategic reasons, severe health and safety concerns or political conflicts.
- Technological and safety standards are strict administration and compliance costs in meeting industrial and health and safety regulations imposed on imported products.

CORE

Business Management Toolkit (BMT)

Question 46.5 - Gijs Van Oosten Jeans

Gijs Van Oosten Jeans sell jeans to customers in the Netherlands. The company buys an average of 15,000 pairs of jeans per month at a cost of $25 each from its supplier in the USA. Gijs Van Oosten Jeans then sell these to its customers in the Netherlands at a price of €35 each.

(a) Define the term *exchange rate*. *[2 marks]*

(b) Use the various exchange rates below to complete the table for Gijs Van Oosten Jeans, rounding to the nearest whole number *[4 marks]*

Exchange rate	Purchase cost ($)	Purchase cost (€)	Sales revenue (€)	Profit or Loss (€)
€1 = $1.30				
€1 = $1.35				
€1 = $1.40				
€1 = $1.45				

(c) Comment on the relationship between changes in the exchange rate and the level of profits for Gijs Van Oosten Jeans. *[4 marks]*

(d) Explain **two** other costs that Gijs Van Oosten Jeans might incur from using a foreign supplier. *[4 marks]*

(e) Examine how a high exchange rate can be both an opportunity and a threat to Gijs Van Oosten Jeans. *[6 marks]*

Finally, in addition to the four government objectives for the economy explained above, consumer and business confidence levels are economic factors that can affect the level of business activity. Furthermore, the actions and activities of competitors can also affect the performance and prosperity of a particular business.

Environmental opportunities and threats (STEEPLE analysis)

Individuals organizations and governments are increasingly concerned about the negative impacts of business activity on the natural environment. Without government intervention, private sector businesses are unlikely to consider the external costs of business activity - the costs incurred by society rather than by the buyer or seller. Examples of external costs include passive smoking, air and noise pollution, packaging waste and global warming. Climate change has been blamed for the increase in natural disasters such as tsunamis and hurricanes.

Changes in social attitudes towards the environment have meant that businesses are increasingly reviewing their practices and adopting various circular business models (see Chapter 51). Firms that do not respect the environment face ruining their reputation and long-term profitability. However, if compliance costs are too high then firms may not be able to afford more environmentally friendly operations. The extent to which businesses consider environmental issues also depends on their aims and objectives, the attitudes of workers and management, the likely impact on their profits and the available resources.

Environmental opportunities and threats also include consideration of the weather and seasonal changes. It might be possible for some businesses to exploit changes in the season, such as tour operators focusing on ski holidays in the winter and beach resorts in the summer. By contrast, severe and adverse weather conditions will affect a large number of businesses, such as theme parks, car wash firms and agricultural farmers. Hurricane Katrina (USA, 2005), severe snowstorms across Europe (December 2010), Typhoon Haiyan (Philippines, November 2013), Australian wildfires (2020) and torrential floods (Germany, 2021) have caused major havoc to businesses. Extreme weather conditions in Russia reduced its GDP by over 1% in 2010. Japan's 9.0-magnitude earthquake in 2011 (the worst in the country's history) caused damage of over $235bn.



Figure 46.8 - The weather has a direct impact on tourism revenues

Health scares, epidemics and pandemics also present major threats to businesses. Examples include mad cow disease (late 1990s), foot and mouth disease (2001) and swine flu (2009). The COVID-19 pandemic caused major turmoil to businesses across the world, with a record number of organizations collapsing.

Theory of Knowledge (TOK)

Can anything good for businesses ever come out of major natural disasters?

CORE

Political opportunities and threats (STEEPLE analysis)

The political stability of a country and its government policies (such as taxation and interest rate policies) can provide both opportunities and threats for businesses. A government that adopts a laissez-faire (free market) approach to managing the economy refrains from intervening in business affairs. The advantage of this approach is that leaving businesses to their own devices should stimulate healthy competition and efficiency gains. It is also more likely to attract foreign direct investment because it is easier to conduct business in such countries. In reality, most countries adopt an interventionist approach to managing the economy by using legislation and policies to oversee business behaviour and to influence the level of business activity.

For example, the use of taxation and government expenditure policies can be used to influence the level of business activity. The government spends the tax revenue that it collects (see Box 46.4), in addition to other sources of government revenue, on a number of areas including social security, healthcare, education and infrastructure such as transportation networks. The spending helps to attract corporate investments and creates business opportunities.



Figure 46.9 - Taiwan's high-speed rail line cost $18 billion

When the economy experiences high rates of economic growth and inflation, so needs to be slowed down, the government can use a combination of higher taxes and reduced government expenditure policies. By contrast, to boost business activity during a recession, the government can use a combination of tax cuts and increased public sector spending, thereby creating many business opportunities.

Box 46.4 - Common examples of taxes

- *Income tax* is a levy on personal incomes from wages, salaries, rent, interest and dividends. It is the main source of tax revenue for most governments.
- *Corporate tax* is a levy on profits. Small businesses tend to be charged a lower tax rate on their profits than large multinational companies.
- *Sales taxes* are imposed on an individual's expenditure, such as Value Added Tax (charged in most European countries) and the Goods & Services Tax (used in the USA and many other parts of the world).
- *Capital gains tax* is a tax on the surplus (known as 'capital gains') made from investments such as shares and real estate.
- *Inheritance tax* is a tax on the value of assets (such as cash or property) passed onto a third party following the death of the owner of the assets.
- *Customs duties* (or tariffs) are taxes on foreign imports.

Theory of Knowledge (TOK)

How do policymakers determine what a 'fair' tax is?

Governments can also use interest rate policies to influence the level of business activity. The interest rate is the price of money, both in terms of the cost of borrowing money and the return for saving money in a bank account. If the economy is growing too fast (an economic boom), the government or the Central Bank is likely to raise interest rates to combat the effects of inflation, and vice versa. For example, in 2018, the Argentinian government raised interest rates to 40% in an attempt to combat inflation rates in excess of 25%.

Raising interest rates makes borrowing less attractive because households and businesses face higher interest repayments on their loans. In addition, those with existing credit card bills, loans and mortgages face escalating interest repayments. Higher interest rates automatically reduce people's disposable income after their interest-bearing loans have been paid. Hence, those with existing loans or debts may need to reduce their overall spending. Overall, an increase in interest rates is likely to reduce consumption and investment expenditure, therefore being a threat to businesses, even though this may help to control inflation in the economy.

An increase in interest rates in a country also tends to stimulate demand for its currency as foreign investors are attracted by better returns on their savings. If Germany and Australia have relatively higher interest rates than Japan or Thailand, then demand for Euros and Australian dollars would tend to rise thereby increasing the price (or exchange rate) of these currencies. However, this causes the price of exports to be relatively higher so is likely to reduce the demand for exports. Hence, higher exchange rates tend to be a threat for domestic businesses in the long run.

Political **corruption** can be a major and ongoing threat for businesses. Data from Transparency International, a global non-governmental organization, show that there is a strong correlation between corruption, poverty and international competitiveness - higher levels of corruption in a country jeopardize the nation's ability to alleviate poverty and to be competitive on an international scale. Box 46.5 shows the most honest countries according to Transparency International's Corruption Perception Index (CPI), with a score of 90-100 being 'very clean'. These countries create greater prospects and opportunities for businesses.

Box 46.5 - Ten most honest nations

Rank	Country	CPI score
1	Demark	88
1	New Zealand	88
3	Sweden	85
3	Switzerland	85
3	Singapore	85
3	Finland	85
7	Norway	84
8	Netherlands	82
9	Germany	80
9	Luxembourg	80

Source: adapted from www.transparency.org

Common mistake

Students often comment that higher interest rates create incentives for people to save more money. In reality, most governments only tend to change interest rates by around 0.25% at a time; hardly an incentive to spend less in order to save more. Some people might save more (probably those without mortgages, credit cards bills and existing loans), but this is highly unlikely for the majority of households and businesses with debts. Hence, higher interest rates have a much larger impact on reducing the spending ability of households and businesses.

Theory of Knowledge (TOK)

To what extent is business knowledge limited by uncertainty about the external environment?

Legal opportunities and threats (STEEPLE analysis)

The government imposes rules, regulations and laws as part of the country's legal framework to ensure that the general public is protected from any potential adverse aspects of business activity. Legislation can also protect the interests of businesses. Common legislation affecting businesses include:

- *Consumer protection legislation* - Laws exist that make it illegal for businesses to provide false or misleading descriptions of their products and services (see Question 46.6 following). Products must meet certain quality standards and be fit for purpose. Businesses are also held liable for any damage or injury caused by their defective products.

- *Employee protection legislation* - These laws protect the interests and safety of workers (see Box 46.6). For example, anti-discrimination legislation helps to ensure that businesses act fairly towards their employees, irrespective of their age, gender, marital status, religion or ethnicity.

- *Competition legislation* - These laws ensure that anti-competitive practices are prohibited to protect customers and smaller businesses from firms with monopoly power. The government acts against businesses deemed to behave against the public interest, such as large firms engaging in price fixing or charging unjustifiably high prices. Competition laws can also present opportunities. For example, copyright, trademark and patent laws give businesses legal protection against competitors replicating their works or inventions. This can stimulate innovation (see Chapter 42), thereby improving the firm's competitiveness.

- The government can also use *deregulation* to provide opportunities for businesses to prosper. Deregulation is the removal of government rules and regulations (bureaucracy) which constrain business activity within a particular industry. It should therefore enhance efficiency and encourage more competition within the industry.



Figure 46.10 - The legal framework protects consumers and businesses

Box 46.6 - Employment legislation

Although countries vary in their use of employment legislation, the laws typically found in most countries include the following:

- *Anti-discrimination laws* make it illegal to discriminate (show prejudice) against individuals because of their gender, race (ethnicity), religion, disability, marital status or age.

- *Equal pay legislation* makes it unlawful for an employer to reward employees differently if they are doing work or jobs deemed to be of equal value.

- *Health and Safety at Work Acts* cover the provision of safe and adequate working conditions. Businesses need to offer a secure and hygienic working environment for their staff.

- *Statutory benefits* are the legal benefits that all businesses are obliged to offer to their workers, such as maternity leave, sick pay, holiday pay and a retirement pension scheme.

- *National minimum wage legislation* requires all businesses to pay a legal minimum rate of pay to their workers, thus creating incentives to work for the lowest paid workers in the country.

CORE

Question 46.6 - Findus horsemeat scandal

In 2013, the UK's Food Standards Agency (FSA) confirmed that meat found in some frozen beef lasagne products from Findus were made from 100% horsemeat. This led to a complete **product recall** of all meat products under the Findus **brand** in 13 countries, including the UK, France and Sweden. The FSA reported that there was no evidence to suggest that the horsemeat caused a food safety risk, but questions were raised about the unethical practice of the European food producer and its failure to comply with product description laws. The company made an official apology to customers and offered full refunds for products purchased.

(a) (i) Define the term *product recall.* *[2 marks]*

(ii) Define the term *brand.* *[2 marks]*

(b) Explain how Findus may have acted unlawfully **and** unethically. *[6 marks]*

ATL Activity 46.1 (Research skills)

Gender equality is the fifth Sustainable Development Goal (SDG) of the United Nations. Investigate the arguments in favour of gender equality - the UN website is a good starting point (www.un.org/sustainabledevelopment/).

Can businesses promote gender equality in the workplace in an authentic and genuine way? Justify your reasoning.

CORE

Question 46.7 - Walmart

Global retailer Walmart was charged with breaking local labour laws for forcing employees to work during their rest breaks without pay. The courts fined Walmart $78 million. Around 1.6 million female workers also filed for **discrimination** charges, claiming that Walmart denied them opportunities for promotion due to their gender. They claimed that Walmart paid male counterparts higher wages. Employees have also staged protests to demand higher pay, calling for a minimum annual salary of $25,000 for full-time workers. Walmart defended its practices stating that its average worker earns $13 per hour - significantly higher than the federal **national minimum wage** of $7.25 per hour.

(a) Define the term *discrimination.* *[2 marks]*

(b) Define the term *national minimum wage.* *[2 marks]*

(c) Justify why organizations such as Walmart need to be fully aware of the legal environment. *[10 marks]*

Ethical opportunities and threats (STEEPLE analysis)

Business ethics are the moral principles that are or should be, considered in business decision-making, based on what is judged to be right or wrong in society. Ethical firms act in a socially responsible way towards their stakeholders (especially their customers, employees and the local community), such as protecting the natural environment by using resources efficiently and minimizing waste. Ethical firms also pay their workers on time, do not employ workers below the legal minimum age or allow their employees to operate in poor working conditions. They do not use misleading marketing or deal with corrupt suppliers, sponsors or governments.

Although there are compliance costs in acting ethically, businesses that are socially responsible can benefit in numerous ways:

- They attract and retain good quality workers - Google, for example, has a very loyal and dedicated workforce, partly because of the astonishing working environment which includes free buffet meals, gym access, laundry and a host of other on-site benefits.
- They attract new customers and retain existing ones - To remain competitive, businesses need to consider the impact of their operations on society and the environment because customers are increasingly concerned about environmental protection and ethical business behaviour.
- Behaving ethically generates good publicity and public relations (see Chapter 29) - Organizations such as The Body Shop, The Co-operative and Friends of The Earth have used their ethical stance to propel their business and mission (cause).

Businesses are increasingly prepared to have external social audits conducted. These are reports on the ethical and social stance of a business, examined and reported by an external agency. The social audit reports both external matters (such as a firm's involvement in community projects and the level of pollution caused by the firm) and internal issues (such as the efficiency of its waste management processes and its ability to provide staff with a safe working environment).

Choosing to be ethical and socially responsible can bring benefits, but there are also compliance costs involved with such decisions. A business might not always be able to pursue the cheapest or the most profitable option due to the costs of being ethical and socially responsible. For example, the cheapest supplier might not be chosen if it is perceived (by customers and other stakeholders) to be an unethical business.

Case study 46.4 - Europe's horse meat scandal

In 2013, the 'horsemeat scandal' spread throughout Europe and affected businesses in many other parts of the world. Food products advertised as containing beef were adulterated with horsemeat, by up to 100% in some cases (see Question 46.6). Horse DNA was found in frozen beef burgers in supermarkets in Ireland and Britain. Retailers such as Tesco and Burger King cut all links with the suppliers found guilty by the European authorities.

Theory of Knowledge (TOK)

How do cultural perspectives and biases affect people's interpretations of what is and what is not ethical business behaviour?

Theory of Knowledge (TOK)

Is 'business ethics' an oxymoron? How can we truly know if an organization's corporate social responsibilities (CSR) are genuinely altruistic rather than for its own gain?

Key concept

With reference to an organization of your choice, discuss how **ethics** in the external environment impacts on its business strategy.

CORE

Business Management Toolkit (BMT)

Evaluation of STEEPLE analysis

In summary, STEEPLE analysis is a situational tool that provides managers with an overview of the factors in the external environment that affect business activity and the issues that should be addressed in any business strategy. It is a useful and straightforward framework that aids management decision-making, such as:

- the potential costs (risks) and benefits of a joint venture, merger or acquisition (see Chapter 6).
- marketing planning, such as the opportunities and threats of broadening a firm's international marketing (see Chapter 34).
- business propositions, such as whether to diversify (see Chapter 45), to expand overseas or to outsource production (see Chapter 38).
- investment opportunities, such as deciding on the location of business (see Unit Chapter 38).
- making links between the political, legal and social environments in order to determine how they might affect the growth strategy of a large multinational company.

Changes in the external environment, which are inevitable, present both threats and opportunities for businesses, so will also affect business strategy. Different businesses are affected by different external factors and to varying degrees, so the tool will vary in purpose and relevance for different businesses. This will largely depend on factors such as:

- *The size of the business* - Smaller and newer firms tend to be less able to cope with external shocks to the business environment.
- *The skills and experience of management* - Experienced and skilled managers are able to predict and successfully react to changes in the external environment and potential crises (see Chapter 41).
- *The degree of brand loyalty* - Businesses with a loyal customer base are less exposed to the threats of competition, so are less affected by external changes such as fluctuations in the exchange rate or changes in prices.
- *The diversity of the firm's operations* - Businesses that have a diversified product portfolio (see Chapters 27 and 47) and have overseas operations are more able to handle changes in the external environment. By contrast, firms that specialise in one or two products in a specific market are more vulnerable to external threats.
- *The level of a firm's gearing* - Gearing refers to the extent to which a business relies on external borrowing (see Chapter 19). Businesses that are highly geared are more defenseless if there are adverse changes in the external environment, such as if interest rates increase.

However, there are some limitations with this tool. As with SWOT analysis (see Chapter 44), the findings in a STEEPLE analysis are only valid at the time of research. Given things in the external environment can change rapidly, the validity of the findings in a STEEPLE analysis may become outdated quite quickly.

Furthermore, it is not realistic to be able to identify or anticipate all possible opportunities and threats using the STEEPLE framework. For example, the impacts of the global financial crash of 2008 and the COVID-19 pandemic of were not anticipated by most businesses and underestimated by every industry.

Finally, as a situational tool, STEEPLE analysis does not provide suggestions for developing appropriate business strategies. Therefore, additional tools are required. Change in the external environment also affect a firm's competitive strategy (its ability to compete against domestic and international rivals), such as exchange rates or government rules and regulations. Management guru Michael Porter believes that business strategy needs to focus on a chosen source of competitive advantage (see Chapter 53). This could be through low prices (such as Ryanair or IKEA) or via outstanding quality (such as BMW or Gucci). Such decisions allow businesses to devise appropriate strategies to maintain or improve their competitiveness in an ever-changing and dynamic and globalized business world.

Key concept

With reference to an organization of your choice, discuss how **creativity** and **change** influence its business strategy.

REVIEW QUESTIONS

1. What does the acronym STEEPLE analysis stand for?
2. How do opportunities differ from threats?
3. What is the purpose of a STEEPLE analysis?
4. How does the social environment present both opportunities and threats for businesses?
5. How does the technological environment present both opportunities and threats for businesses?
6. How does the economic environment present both opportunities and threats for businesses?
7. How do environmental factors create both opportunities and threats for businesses?
8. How does the political environment present both opportunities and threats for businesses?
9. How does the legal environment provide both opportunities and threats to businesses?
10. How do ethical factors create both opportunities and threats for businesses?

KEY TERMS

The **business cycle** refers to the fluctuations in the level of business activity over time. Economies tend to move through the cycle of booms, recessions, slumps, recovery and growth.

The **economic environment** covers the key economic objectives of the nation, namely, to control inflation, to reduce unemployment, to achieve economic growth and to achieve a healthy international trade balance.

Environmental factors in a STEEPLE analysis are the ecological influences that have a direct impact on the operations of an organization, such as climate change and green technologies.

The **ethical environment** refers the moral values and judgements (of what is right) that society believes businesses need to adhere to in their decision-making.

The **external environment** refers to a framework of the (STEEPLE) factors that are beyond the control of any individual organization, but which affect all businesses and their operations.

The **legal environment** refers to the framework of rules, regulations and laws as part of the country's legislative framework that govern business activity.

The **political environment** in a STEEPLE analysis refers to the role that governments play in business operations, such as rules or restrictions on trade.

Social factors in a STEEPLE analysis are the influences on businesses related to people in society, their lifestyles and their beliefs (or values).

STEEPLE analysis is an analytical framework used to examine the opportunities and threats of the social, technological, economic, environmental, political, legal and ethical factors that affect business activities.

The **technological environment** refers to scientific knowledge and application to the external environment that presents constant threats and opportunities, such as Internet technologies.

Chapter 47
Business Management Toolkit (BMT) 4 - Boston Consulting Group (BCG) matrix

"There are two primary choices in life: to accept conditions as they exist or accept the responsibility for changing them.""
- Denis E. Waitley (b.1933), American motivational speaker and best-selling author

Boston Consulting Group (BCG) matrix

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. The Boston Consulting Group (BCG) matrix is both a situational and decision-making tool.

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The **Boston Consulting Group matrix** (or the **Boston matrix** for short) was devised by Bruce D. Henderson (1970). The BCG matrix is a situational and decision-making tool that helps managers plan for a balanced *product portfolio* (see Chapter 27). For example, Japanese conglomerate Hitachi has a product portfolio that includes goods as diverse as consumer electronics, car parts and high-speed trains. A product portfolio can also contain the various strategic business units (SBUs) of an organization. This refers to divisions of an organization, such as Gatorade, 7-Up, Lay's, Doritos, Taco Bell, Pizza Hut and KFC, which are owned by PepsiCo.

The BCG matrix looks at two dimensions: **market share** and **market growth** in order to assess new and existing products in terms of their market potential (see Figure 47.1).

Case study 47.1 - Unilever

Unilever is an Anglo-Dutch multinational company, founded in 1929. Its product portfolio is vast, including food, beverages, personal care and cleaning products. Unilever owns over 400 brands, which include: Axe/Lynx, Ben & Jerry's, Cif, Dove, Flora, Lipton, Magnum, Marmite, Persil, PG Tips, Pot Noodle, Slim Fast, Tony & Guy and Vaseline.

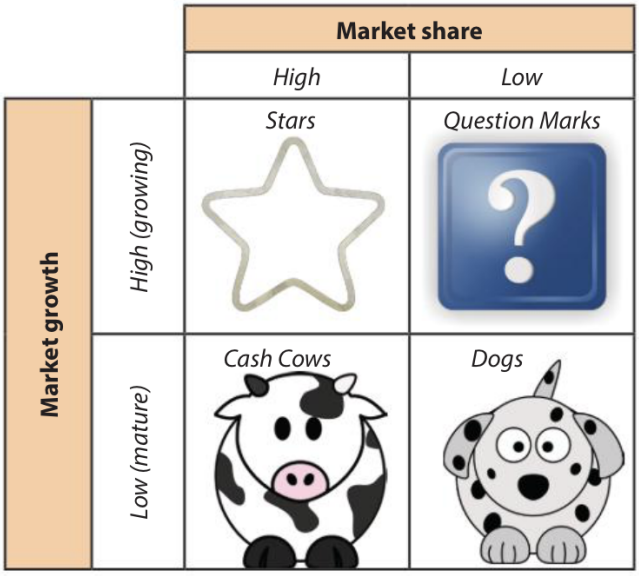

Figure 47.1 - The BCG matrix

A multi-product business would place each individual product or brand in its product portfolio into one of the quadrants based on the product's relative *market share* and the product's *market growth* in the industry. There are four possible outcomes:

- **Dogs** are products with low market share operating in a low growth market. Dogs do not generate much cash for the business as the market tends to be stagnant or declining, so businesses may need to use product extension strategies (see Chapter 27) or try to dispose of the dogs (withdraw them from the market). Businesses that have too many dogs may face liquidity problems (see Chapter 20).

- **Question marks** (or **problem children**) are products that operate in a high market growth sector but have low market share. This can be a concern to management as it may suggest inferior marketing and/or product quality. The business should analyse reasons for its low market share and then develop strategies to gain a higher share of the growing market. This means question marks (also known as **wild cards**) are the main users of cash in the BCG matrix but do not generate much, if any, profit. As the name suggests, it is not always clear whether a business should invest more in question mark products.

- **Stars** are products that operate in high growth markets and have high market share. Hence, stars are successful products that tend to generate high amounts of cash for a business. Businesses will tend to spend money to develop and promote their star products. The cash generated from stars can be used in an attempt to turn some of the question mark products into stars. It is hoped that stars will eventually turn into cash cows for the business.

- **Cash cows** are products with high market share competing in a low-growth market. Such markets tend to be mature and the products are very well established (such as Coca-Cola in the soft drinks industry or Apple's iPhone in the smartphone market), thereby generating remarkable net cash flow. Cash cows generate large amounts of profits. However, some cash cows run the risk of becoming dogs, so businesses tend to use extension strategies to prolong their high earning potential.

Henderson said that successful businesses have a portfolio of products with different market growth rates as well as different rates of market share. Product portfolio analysis allows a business to decide which products should receive more (or less) investment. Products that do not have high market share may be withdrawn or remarketed, for example. The analysis also allows a business to develop appropriate growth strategies (see Chapter 45) by adding new products to an existing or new product range.



Figure 47.2 - The Coca-Cola Company's product portfolio includes Sprite and Fanta

The BCG matrix shows that the ideal product portfolio for a business is to have a balanced portfolio, which might include some stars, a few question marks and several cash cows. It is important to note that the BCG matrix is not a static business model. The money generated from cash cows is used to turn the question marks into stars, otherwise they may quickly become dogs. Similarly, stars may ultimately become cash cows. Appropriate marketing strategies need to be devised to foster these changes. Managers also need to decide whether to spend money on reviving the demand for dogs or to withdraw all investments in them, thereby releasing cash for other products. Hence, it is important that a business has a balanced and diverse range of products in its portfolio.

A diverse product portfolio is important for an organization's cash flow because only selling to a single market limits the revenue streams of the business (see Chapter 16). For example, French fashion designer company Agnès b has a broad product portfolio that spans beyond clothing to also include confectionary, flowers, food (cafés and restaurants), shoes and fashion accessories (handbags, sunglasses, wallets, travel bags, belts and watches). Having a balanced and diverse product portfolio also helps to spread risks because a decline in sales for one product may be offset by favourable sales of other products in the portfolio.

A criticism of the BCG matrix is the assumption that higher profits come from higher sales or market share. This is not necessarily the case. For example, Disneyland Paris made huge losses between 2002-2006 despite receiving large amounts of revenue and having a high market share in the theme parks industry. The company even had to raise a further $350m

through share issues (see Chapter 15) in 2005 to prevent it going into liquidation (see Chapter 20). The attractiveness of its brand meant the Walt Disney Company gained high market share quickly, but still faced the problem of recouping its high redevelopment costs. The theme park was burdened with debt, equal to around 15 times its gross earnings. In 2017, the Walt Disney Company needed to invest an additional €1.5 billion ($1.75bn) to strengthen the Park.

In addition, whilst the BCG matrix can provide a quick synopsis of a firm's product portfolio, it fails to explain the reasons for the position of the products in the grid. Hence, the BCG matrix (as with any other business management model) should be used in conjunction with other tools such as Ansoff's growth matrix (see Chapter 45).

A common marketing strategy used is to increase the product mix, enabling the business to generate more revenue and to spread its risks. Product portfolio analysis and the BCG matrix can help managers to determine their product strategy. The tool suggests four different strategies to deal with stars, dogs, question marks and cash cows (see Figure 47.1).

		Market share	
		High	*Low*
Market growth	*High (growing)*	*Harvest*	*Build*
	Low (mature)	*Hold*	*Divest*

Figure 47.3 - The BCG matrix and product strategy

- **Build** - This strategy is used to turn question marks into stars by investing necessary resources to increase market share. If nothing is done to improve the firm's market share, cash will be drained from the business.
- **Harvest** (or **milk**) - This strategy involves reaping the benefits (profits) of a product. The purpose is to turn stars into cash cows. This might require huge amounts of advertising to turn the product into a cash cow. Harvesting or milking cash cows enable the firm to use money from sales of established products in established markets to fund star products and question marks, thereby safeguarding the organization's future.
- **Hold** - This strategy involves investing enough resources to keep cash cows in their current position in the BCG matrix. Investment is likely to be minimal as market growth for cash cows will be low.
- **Divest** - This strategy involves phasing out or selling off dog products. This frees up resources to be used elsewhere, such as investing in certain question mark products. Some of the question marks might also face divestment, especially those that are unlikely to turn into stars.

Within the BCG matrix, the question marks are the main users of cash whilst the cash cows are the main generators of cash. The optimal product portfolio strategy is one that takes advantage of the firm's strengths (stars and cash cows) in order to develop other attractive opportunities (turning question marks into stars and possibly reviving or extending the product life cycle of dogs).

CORE

Question 47.1 - Mattel

Mattel is one of the world's largest manufacturers of toys. Established in 1945, the American company has profited from products such as Elmo cuddly toys (of Sesame Street). Mattel's brands include Barbie dolls, Fisher-Price, Hot Wheels, Matchbox, Tyco, UNO, Pictionary and Scrabble. Mattel's market dominance is backed by other products in its **broad product** portfolio, such as strong sales of toys based on Pixar's animated films *Cars* and *Toy Story*.

(a) Define the term *product portfolio*. *[2 marks]*

(b) Explain the importance of a broad product portfolio for a business such as Mattel. *[6 marks]*

Question 47.2 - CK Hutchison Holdings

CK Hutchison Holdings is a large conglomerate multinational company with operations in over 50 countries. It has four core strategic business units: ports and related services, retail, infrastructure and telecommunications. The company is one of the world's leading container terminal operators with operations in 52 ports in 26 countries. Its retail division includes a diverse **product portfolio** spanning health and beauty, supermarkets and consumer electronics in 16,200 stores worldwide. CK Hutchison's Infrastructure Division has a diverse portfolio of investments in energy infrastructure, transportation infrastructure, water infrastructure, waste management and household infrastructure. The company is also a leading operator of global mobile telecommunications and data services, including mobile broadband services.

Source: adapted from https://www.ckh.com.hk/en/about/

(a) Define the term *conglomerate*. *[2 marks]*

(b) Define the term *product portfolio*. *[2 marks]*

(c) Examine the reasons why CK Hutchison Holdings needs a different marketing mix for each of its distinct products and services. *[6 marks]*

Theory of Knowledge (TOK)

When does the life of a product actually begin? What determines whether marketers consider launch or R&D (research and development) to be the first stage of the product life cycle?

CORE

Evaluation of the Boston Consulting Group matrix

The BCG matrix is a useful situational and decision-making tool because it provides a clear visual overview of a firm's product portfolio. It enables managers to see at a glance whether the business has a balanced portfolio. For example, if there are too many dogs or wild cards, the business might struggle to compete successfully in the future. At the same time, a business that is overly reliant on a few cash cows might need to broaden its product portfolio to include more promising question marks and stars to protect the future of the business.

However, the BCG matrix only provides a snapshot of the position of a firm's products at a particular point in time and does not account for changes in the external environment (see Chapter 46). The tool does not enable managers to know or understand why a product falls into a particular quadrant, as there are so many potential factors that determine whether a particular product succeeds or fails.

Furthermore, there is an assumption that higher market share equates to greater profits. This is not always the case, especially if market share has been gained at the opportunity cost of lower prices and profit margins (see Chapter 28).

Therefore, the BCG matrix is of little use in predicting the future success of the products in a firm's portfolio. For example, no one could predict the sudden and huge growth in the market for personal protection equipment (PPE), such as face masks and hand sanitizers, before the global COVID-19 coronavirus pandemic. Likewise, a fast-growing market today may not be sustainable and experiences a rapid decline in the near future. Of course, no technique or tool ever guarantees business success. To make the right decisions, businesses are likely to need to carry out further analysis using additional business management tools.

REVIEW QUESTIONS

1. What is the Boston Consulting Group matrix?
2. What are the four quadrants in the Boston Consulting Group matrix?
3. Why is it important for a business to have a balanced product portfolio?
4. What are the various strategies suggested to deal with the various category of products in the BCG matrix?
5. What are the limitations of the BCG matrix as a business management tool?

KEY TERMS

The **Boston Consulting Group** matrix is a situational and decision-making tool use for analysing the product portfolio of a business. It shows whether products have a high or low *market share* and operate in high or low market growth industries.

Cash cow refers to any product in a firm's portfolio that generates significant money due to its large market share in a mature market.

Dogs are products in the BCG matrix that have low market share and operate in low growth or stagnant markets. Hence, dogs do not generate much cash or profit for a business.

Question marks (or wild cards) are products in the BCG matrix that compete in high market growth industries but have low market share. They consume lots of cash but do not generate much profit, if any.

Stars are products in the BCG matrix that have high or rising market share in a high growth market. They have the potential to become cash cows if funded and marketed appropriately.

Chapter 48
Business Management Toolkit (BMT) 5 - Business plans

"A goal without a plan is just a wish."
- Antoine de Saint-Exupéry (1900 - 1944), French poet and aviator

Business plans

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. Business plans are a type of planning tool.

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A **business plan** is a formal report detailing the key aspects of a business idea or or proposition and how the organization sets out to achieve this. It is a management planning tool that requires decision makers to consider the marketing, financial and human resources of the organization in the pursuit of its business objectives. Business plans are commonly used by owners and entrepreneurs when setting up a new business. To produce the formal document, managers and entrepreneurs are required to think and plan ahead, including conducting the necessary research required to complete the report and minimise the risks associated with the plans.

The business plan also helps to reassure financial lenders, such as commercial banks and business angels (see Chapter 15), that the entrepreneur has comprehensively researched the business idea and has given reasons to support their proposal. Investors will assess both opportunities and risks that may be reflected in a business plan before making any decisions.



Figure 48.1 - The business plan is an essential management planning tool

They will also look for potential problems with the proposal, even if these have not been included in the business plan. Therefore, it helps financiers to make a more objective judgement regarding the organization's likely chances of success and hence its ability to repay the loans. The business plan can also be used by other stakeholders such as shareholders to assess the potential gains from their investment in the business.

Although there is no universally accepted format for writing a business plan, the contents of a typical business plan include the information shown in Table 48.1.

Table 48.1 - Contents of a typical business plan

Component	Contents
The business	• Name and address of the proposed business (for new businesses) • Cost of premises and other start-up costs (for new businesses) • Details of the owner(s) and past business experience • The type of business organization, e.g., sole trader or partnership • Quantifiable objectives of the proposed business or project.
The product	• Details of the good(s) and/or service(s) being offered • Supporting evidence showing why customers will pay for the product(s) • Where and how production will take place, e.g., the equipment that is needed • Details of the suppliers of resources, such as raw materials and/or components • Costs of production, i.e., the expected costs of running the business • Pricing methods to be used (see Chapter 28).
The market	• The expected number of customers or the forecast level of sales • The nature of the market such as customer profiles and market segmentation • The expected growth of the market in the foreseeable future • Competitor analysis, e.g., market share, strengths and weaknesses.
The finance	• Proposed sources of finance (see Chapter 15), i.e., how the business idea or proposal will be funded • Break-even analysis (see Chapter 39) • Collateral (financial security and guarantees) in case the borrower defaults on the loan • Cash flow forecasts and plans to deal with cash flow problems (see Chapter 20) • Forecast profit and loss account (see Chapter 17) for the first year of trading • Forecast balance sheet (see Chapter 17) showing the firm's financial health • A forecast rate of return for investors of the business venture.
The personnel	• The number of people and details of the job roles of the workers likely to be employed • Organizational structure of human resources (see Chapter 8) • Details of payment systems, e.g., wages, salaries and remuneration packages.
The marketing	• Market research and test marketing (see Chapter 26) • The distribution plan, detailing where the products will be sold • Details of the promotional mix (see Chapter 29) to target customers • Details of any unique or distinctive selling point to differentiate the product from rival ones in the market.

Many business plans have sections devoted to a SWOT analysis (see Chapter 44) and a contingency plan (see Chapter 41) outlining what the entrepreneur will do if things do not go as planned. Finally, any appropriate supporting evidence (such as statistics, charts and other reference material) should appear in an appendix at the back of the business plan.

Business plans are particularly important for business start-ups (see Chapter 1). Poor cash flow management (see Chapter 20) is one of the main causes of business failure. Hence, it is common for a new business to include a cash flow forecast in the business plan so that provisions can be made to cover any shortfalls.

As bank managers are busy people, a typical business plan is often no more than 5 to 6 pages long. If this is not possible, such as in the case of a proposal for an international joint venture, then an **executive summary** is written and placed at the front of the business plan. This summarises the information given in the main report of the business plan, highlighting the key points and conclusions. The executive summary can be read within a few minutes to get an overview of the business plan and the bank manager can then decide whether or not to read the rest of the document.

ATL Activity 48.1 (Research skills)

Learn more about how to write a business plan by using an appropriate online tool.

Some suggestions include these: www.bplans.com, www.simplybusiness.co.uk and www.gov.uk/write-business-plan.

Evaluation of business plans

Business plans are important as a management planning tool as they form a strategic focus. In particular, start-ups and small businesses need to focus on their unique identities, target markets and their goods or services tailored to match the needs and wants of the market.

Furthermore, a business plan provides a framework or structure as a planning tool to keep the business focused on its goals and objectives. Used appropriately and referred to regularly, a business plan helps decision makers and entrepreneurs to manage their priorities and different areas of focus.

Business plans can also be important for managing change in business organizations. With good planning, decision makers and entrepreneurs regularly review key performance indicators (such as sales growth or market share data), track progress and pursue new business opportunities. Business plans provide a detailed and structured roadmap, which can be adjusted if needed, thereby helping to improve the chances of commercial success.

However, to produce an appropriate business plan is likely to be both time consuming and costly. For example, there is a need to undertake sufficient market research (see Chapter 26), as well as making detailed plans for the different functional areas of the business (operations management, marketing, human resources and finance) and contingency plans (see Chapter 41).

CORE

Question 48.1 - DS Bakery



Denis Sagide is a recent graduate of Business Management. He intends to open a bakery business on the outskirts of Nairobi, Kenya. He plans to establish the business as a sole trader, being well aware of the risks this carries, as well as the potential benefits. He has found suitable premises and feels confident about being able to recruit suitable people to work at the bakery. Denis Sagide has produced a detailed business plan for DS Bakery in his attempt to secure external finance to help him to start the business.

(a) Define the term *business plan.* *[2 marks]*

(b) State **two** key elements of a business plan. *[2 marks]*

(c) Explain **two** reasons why DS Bakery might benefit from the use business plans. *[6 marks]*

Furthermore, no amount of forward planning can eliminate risks. For example, new businesses that were set up in 2019 would not have planned for the global recession caused by the outbreak of the COVID-19 virus which caused a worldwide pandemic.

Although business plans are commonly used by new start-ups, quite often the owners and entrepreneurs of these businesses have limited experience. Hence, their business plans may lack depth and breadth of data and information. Even with some experience, the usefulness of business plans will depend on how accurate the forecasts are (such as sales forecasts and cost structures) as well as whether the right strategies are implemented effectively in a continually changing business world. Simply having a business plan does not guarantee success no matter how comprehensive and detailed the plan might be.

Nevertheless, business plans as a planning tool ultimately allows organizations to see the bigger picture. They can include additional business management tools such as SWOT analysis (see Chapter 44), STEEPLE analysis (see Chapter 46) and aspects of Porter's generic strategies (see Chapter 53). In fact, all other 14 tools in the BMT can be used or included in business plans, allowing decision makers and other key stakeholders to get a clearer picture of the business and its intentions. Without an effective plan, businesses may not even realize things have gone wrong before it is too late. As Benjamin Franklin (1706 - 1790), one of the Founding Fathers of the United States, famously said, "*By failing to prepare, you are preparing to fail.*"

CORE

Key concept

If **change** is inevitable, is there any merit in creating static business plans?

Key concept

To what extent does **creative** business planning lead to organizational success?

REVIEW QUESTIONS

1. What is a business plan?
2. Why do entrepreneurs and business owners use business plans?
3. What information is likely to be included in the contents of a typical business plan?
4. Why are business plans of particular importance for business start-ups?
5. What are the limitations of business plans?

KEY TERMS

Business plan refers to the document that sets out a business idea or proposition, including the objectives, resources (marketing, operations, personnel and finance) and corporate strategies.

An **executive summary** is a synopsis or abstract of the information provided in the main section of a business plan, highlighting the key points and conclusions.

Chapter 49
Business Management Toolkit (BMT) 6 - Decision trees

"Whenever you see a successful business, someone once made a courageous decision."
- Peter F. Drucker (1909 - 2005), Management consultant, educator and author

Decision trees

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. Decision trees are a type of decision-making tool.

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A **decision tree** is a quantitative decision-making tool. It is a diagrammatic representation of the different options that are available to a business in the decision-making process, showing the probable outcomes of different strategic options. The tool allows managers and entrepreneurs to calculate the expected value of each decision in order to choose the best option to pursue. Essentially, decision trees help people to decide whether the expected net financial gain from a decision is worthwhile.

For example, consider the following options available to Ian Nelson who is deciding whether or not to sell his apartment in Liverpool. If he sells it this year, he could get $600,000. However, waiting until next year when the housing market is expected to improve increases his chances of selling the apartment at a higher price. Suppose the following factors need to be considered:

- Ian Nelson could sell the property at the current market price of $600,000. This option would incur costs of $10,000 for estate agency and solicitors' fees. Hence, this option would yield a net return of $590,000.
- He could postpone the sale until next year with a 65% chance of receiving a higher price for the apartment. The estimated value of Ian Nelson's property is $650,000 if he sells it next year. Costs would rise to $12,000. Hence, the net return would be $638,000.
- However, reports suggest there is a 25% chance of house prices remaining stable and a 10% chance of the prices declining within the year. If property prices in Liverpool do drop, Ian Nelson's apartment is estimated to be worth $530,000 after associated costs.

Ian Nelson can now use this information to calculate the expected value of each decision. This is done by multiplying the values of each outcome by its probability and then adding up the results. A decision tree is the diagrammatic representation of this process (see Figure 49.1). The rules used to construct and interpret decision trees are as follows:

- The diagram is constructed from left to right.
- **Decision nodes** are shown as squares. These are used when there is a decision to be made, such as whether to launch a new product, to invest in new machinery or to expand into overseas markets. In the above example, Ian Nelson has two options, one of which has a definite outcome (selling today). The decision maker has at least some control over decision nodes.

- **Chance nodes** (or **probability nodes)** are shown as circles. These are used to show the different possible outcomes of a decision. Typical outcomes include criteria such as 'failure or success' and 'improvements or deteriorations.' If Ian Nelson opts to sell his apartment next year (i.e. chance node B in Figure 49.1), there are three possible outcomes, none of which will definitely happen. Businesses and decision makers do not have direct control over chance nodes.

- For each chance node, there will be two or more routes (outcomes). These show the **probability** of the different outcomes for each chance node. The probabilities for each chance node must add up to 1.

- The actual values of each outcome are stated at the end of each **branch**. The costs of each option must be deducted when calculating the net figure for each outcome.

- Each rejected decision (unwanted outcome branch) of the decision tree is cut-off (rejected), indicated by two parallel lines. This will then leave just one best option to follow.

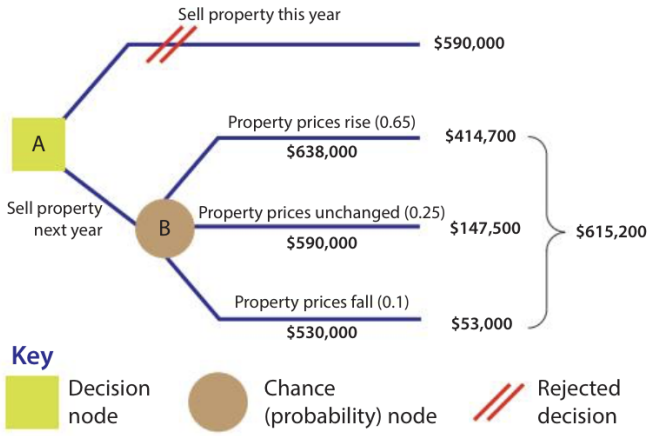

Figure 49.1 - Decision tree for Ian Nelson

The expected values in Figure 49.1 (those appearing at the end of each branch) are calculated as follows. The **expected value** (or **expected monetary value**) refers to the average outcome if the decision was made many times over. It is calculated by multiplying the net value of a decision by its probability.

- The decision to sell the property today would generate a known value of $590,000, i.e., $600,000 minus the transactions costs of $10,000.

- For chance node B, the decision to postpone the sale has a 65% chance of earning $638,000 (after associated costs) so the expected value is $638,000 × 0.65 = $414,700.

- There is a 25% chance that property prices will remain unchanged in the next year. Hence the expected net outcome in this case would be $590,000 × 0.25 = $147,500.

- Finally, there is a 10% chance that property prices will fall within the year. Hence, the expected value in this case is $530,000 × 0.1 = $53,000.

- Therefore, the total expected value of chance node B is $414,700 + $147,500 + $53,000 = $615,200.

The above analysis suggests that Ian Nelson should delay the sale of his property because the total expected value will be higher ($615,200 compared to $590,000, i.e. a net gain of $25,200). Hence, decision trees can help managers to make more informed decisions about business investments. The advantages and disadvantages of decision trees are outlined in Table 49.1.



Figure 49.2 - Decision trees can help with investment decisions

Table 49.1 - The advantages and disadvantages of decision trees

Advantages of decision trees	Disadvantages of decision trees
They allow managers to present problems in a visually clear and logical manner.	The probabilities in a decision tree are only estimates and subject to forecasting errors.
All potential options and outcomes can be seen at the same time, helping to speed up decision-making.	Assigning probabilities can be subjective so results can be deliberately biased to justify the preferences of the management.
They consider the risks involved in decision-making, including potentially negative outcomes.	The technique does not necessarily reduce the scale and scope of risks involved in decision-making.
They enable more scientific and objective decisions to be made because all associated costs of the various decisions are considered.	Delays in the planning process can invalidate the data by the time a decision is implemented, yet time lags are often inevitable in the real business world.
As a visual and quantitative tool, they provide insight to a problem, rather than having to rely on people's views, intuition or feelings about the problem.	They are based on quantitative data only, so qualitative factors (such as the effects on staff morale or the compatibility of a decision with the firm's goals) are ignored.

Question 49.1 - Drisner Traders Ltd.

Drisner Traders Ltd. is considering a move into overseas markets. The Australian company is deciding between two locations: Kazakhstan or South Korea. Market research results are shown in the table below. All financial figures are expressed in $ for ease of comparison.

Kazakhstan	Probability	Costs/Revenues ($)
Cost		250,000
High return	0.6	400,000
Low return	0.4	250,000

South Korea	Probability	Costs/Revenues ($)
Cost		175,000
High return	0.75	300,000
Low return	0.25	180,000

(a) Construct a decision tree to show which of the two locations is best for Drisner Traders Ltd., based on financial grounds. *[5 marks]*

(b) Discuss the value of decision trees as a decision-making tool for Drisner Traders Ltd. *[10 marks]*

Question 49.2 - Evgenii Gvozdev Beverages

Evgenii Gvozdev Beverages (EGB) produces traditional Russian herbal drinks. The company's products are well known in Moscow and neighbouring cities in Russia, the only country it currently operates in. With **secondary market research** data suggesting that sport and exercise are becoming increasingly popular, EGB is considering entering the market for energy drinks.

The success of the proposal is largely dependent on the level of economic growth in the region over the next five years. EGB is considering several options to expand overseas, although the company can only afford to implement one of these initially. The estimated costs and benefits of the options are shown below:

Option	Economic growth	Chance	Return	Cost
Kazakhstan	Improve	50%	$16 m	$10.6 m
	Unchanged	30%	$10 m	
	Worsen	20%	$4 m	
Latvia	Improve	60%	$18 m	$9.8 m
	Unchanged	30%	$8 m	
	Worsen	10%	$2 m	
Belarus	Improve	40%	$18 m	$11.3 m
	Unchanged	30%	$7 m	
		30%	$(2 m)	

(a) Define the term *secondary market research*. *[2 marks]*

(b) Construct a fully labelled decision tree and calculate the predicted outcome for each option faced by EGB *[5 marks]*

Question 49.3 - Mitrovska Educational Resources

Mitrovska Educational Resources (MER) is considering expanding into one of three locations. The expected costs and revenues are shown in the table below. The Chief Financial Officer, Sanja Mitrovska, has made it clear that the company only has the funds to pursue one of these growth options.

Project		Probability (%)	Cost ($m)	Revenue ($m)
Macedonia			100	
	Success	50		215
	Failure	50		80
Bulgaria			80	
	Success	65		180
	Failure	35		75
Serbia			90	
	Success	60		175
	Failure	40		90

(a) Using the information above, construct a decision tree diagram showing which project MER should pursue. Show all your working out and include an appropriate key for your diagram. *[6 marks]*

Evaluation of decision trees

Decision trees, as a quantitative decision-making tool, help managers to make choices in an informed and logical way. The potential choices are considered, based on the probabilities and risks associated with the various options the business faces. Hence, the tool helps managers to minimize the risks associated with decision-making. The probable costs and benefits (financial returns) of different decisions are presented in an easy-to-understand way.

However, as with all quantitative tools, decision trees have their limitations. Importantly, the probabilities are only estimates and are prone to errors in research as well as subject to deviation due to unexpected changes in the external environment (see Chapter 46). Furthermore, risks are not diminished because of the forecasted outcomes in a decision tree. Hence, decision trees need to be used in relation to other Business Management tools prior to making any confirmed decisions. For example, decision trees might be included as part of an overall business plan (see Chapter 48), with consideration of various growth strategies. This could include examination of Porter's generic strategies (Chapter 53) as well as Hofstede's cultural dimensions for businesses contemplating growth in overseas markets (see Chapter 54).

Theory of Knowledge (TOK)

To what extent do emotions and reason influence decision-making in business organizations?

Key concept

With reference to an organization of your choice, examine how **change** and **ethics** affect business decision making.

Common mistake

Candidates often conclude that businesses should not pursue a particular project because of the high risks involved. However, all business decisions carry an element of risk. Taking calculated risks is not irrational business behaviour. Mark Zuckerberg, co-founder of Facebook, said that the biggest risk for entrepreneurs is not taking any risks, especially in a rapidly changing business world.

REVIEW QUESTIONS

1. What is a decision tree?
2. Why might businesses choose to use decision trees?
3. What is the difference between a chance node (or probability node) and a decision node?
4. How are rejected decisions shown in a decision tree diagram?
5. What are the limitations of decision trees as a decision-making tool?

KEY TERMS

Chance nodes are used to show the different probable outcomes of a decision. They are shown as circles. Probabilities (or chances) are generally beyond the control of a business.

Decision nodes are used when there is a choice or decision to be made. The nodes are shown as squares. The decision maker has at least some control over decision nodes.

Decision trees are a quantitative decision-making tool that calculates the probable values of different options available to a business. The tool helps managers to minimize the risks of decision-making.

The **expected value** (or **expected monetary value**) refers to the average outcome if the decision was made many times over.

Rejected decisions are the unwanted outcome branches in a decision tree. They are indicated by the use of two parallel lines for all branches or options that are undesirable.

Chapter 50
Business Management Toolkit (BMT) 7 - Descriptive statistics

"Doubt is the key to knowledge."
- Persian proverb

Descriptive statistics

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. Descriptive statistics are a type of decision-making tool. The syllabus specifies 8 types of descriptive statistics as part of this Business Management tool: (i) Mean, (ii) Mode, (iii) Median, (iv) Bar charts, (v) Pie charts, (vi) Infographics, (vii) Quartiles, (viii) Standard deviation.

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Descriptive statistics are tools used to summarize statistical data in order to help managers and decision makers to analyse their significance. The use of descriptive statistics can help to reduce the risks associated with business decision-making because the tools provide better information to managers and entrepreneurs who are able to make more objective and well-informed choices.

Theory of Knowledge (TOK)

Interpretation is a key concept in the TOK course and is useful as a critical lens when examining statistical analyses in Business Management. For example, there is no real consensus about what makes an ideal or acceptable sample size for market research purposes. However, this clearly impacts how analysts interpret the significance of research findings and results.

Top Tip!

We can also interpret data through inductive and deductive methods of reasoning and content analysis. Enabling students to develop the skills to consider the value (benefits), as well as the concerns (limitations) about different approaches to interpreting data, is an important foundation for critical and reflective thinking.

(i) Mean

The **mean** (or **arithmetic mean**) is the most commonly used method to calculate averages in data sets. It is the sum of all items divided by the number of items in a data set. Take the example of a data set for TV advertising revenue in the United States from 2019 to 2023:

Year	2019	2020	2021	2022	2023
$ billions	73.1	66.5	72.3	76.5	78.8

To calculate the mean average TV advertising revenue for this 5-year period, we need to add the total amount of revenue and divide this by the number of items in the data set. Hence, the mean is calculated as:

- Total TV advertising revenue = 73.1 + 66.5 + 72.3 + 76.5 + 78.8 = 367.2
- Number of years = 5
- Mean = 367.2 ÷ 5 = 73.44

Hence, the mean value of TV advertising revenue in the US for this time period is $73.44 billion.

Question 50.1

The data below shows the value of television advertising expenditure in the United Kingdom for the period 2011 to 2020. Values are in billions of pounds sterling (£).

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
£bn	4.16	4.42	4.64	4.91	5.27	5.28	5.11	5.11	4.93	4.35

Source: adapted from Statista

(a) Calculate the mean to 2 decimal places. *[2 marks]*

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(ii) Mode

The **mode** (or **modal average**) is the number that occurs more frequently than any other value in a data set. For example, suppose a retailer records the number of sales of 330ml bottles of Coca-Cola at its store for the past 30 days:

36	32	36	34	36	37	34	36	31	34
28	29	40	39	39	32	36	32	36	36
34	37	32	36	28	36	37	31	36	32

On ten of the 30 days, the retailer sold 36 bottles. This number occurs more times than any other so is the mode value (unit of sales) for the retailer.

36	32	**36**	34	**36**	37	34	**36**	31	34
28	29	40	39	39	32	**36**	32	**36**	**36**
34	37	32	**36**	28	**36**	37	31	**36**	32

Using a tally system, we can see the data set reveals the following, which again shows the mode is 36 bottles of Coca-Cola sold by the retailer.

Number of bottles	Frequency
28	2
29	1
31	2
32	5
34	4
36	10
37	3
39	2
40	1

The mode for a data set can also be seen from a graph, chart or infographic. For example, suppose that a researcher surveys 100 people to find out which flavour of ice cream was the most popular. The results can be tallied or shown in a pictograph as shown on the following page:

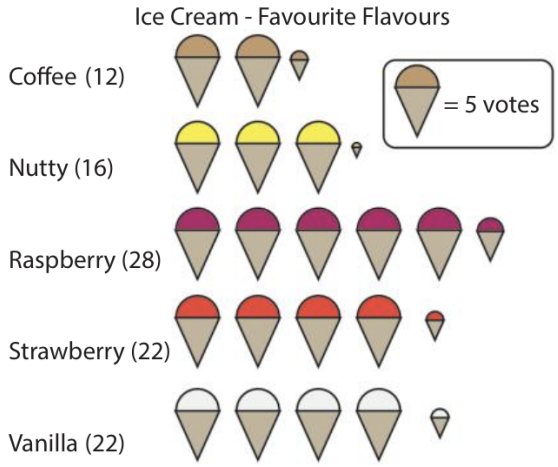


Figure 50.1 - Pictograph showing people's favourite ice cream flavours

It is immediately visible that most people responded to this survey by saying raspberry flavoured ice cream was their favourite. This occurred more times (28) than for any other flavour in the data set. Hence, raspberry is the modal average answer from the research respondents.

(iii) Median

The **median average** (or simply the **median**) refers to the middle number in a data set when all items are ranked in numerical order. To find the median, we must first place the data in order of size. For example, suppose the data below represents the sales figures for a firm for a period of 7 months (figures in $ million).

Month	1	2	3	4	5	6	7
Sales ($m)	6	3	8	3	6	4	5

The first step to calculating the median average is to place the sales figures in order of size:

Sales ($m)	3	3	4	**5**	6	6	8

The median is defined as the value of the data item in the middle of the list. In this case, the median is **5**.

So, what happens if there is an even number of data items, such as sales figures for eight months, as shown below?

Month	1	2	3	4	5	6	7	8
Sales ($m)	5	7	3	9	3	6	2	6

In this case, the same procedure occurs with the numbers in the data set being placed in order of size. However, this time there are two central items in the data set.

Sales ($m)	2	3	3	**5**	**6**	6	7	9

So, in this case, the median is given as the midpoint between these two central value, i.e. (5 + 6) / 2 = **5.5**.

Question 50.2 - Esswood Campers



Nicola Esswood owns and runs her own camping site in New Plymouth, New Zealand. Located near the waterfront, Esswood Campers thrives in the summer season but suffers from a lack of tourists in the winter months. Her sales forecasts for the next twelve months, based on historical data, are shown below.

	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb
Sales ($)	3500	3000	3000	2500	2800	2600	2900	3000	3600	4500	4200	4000

(a) Calculate the (i) mean, (ii) median and (iii) modal averages from the sales data above. *[3 marks]*

(b) Calculate the range and comment on your findings. *[3 marks]*

(c) Examine how descriptive statistics might be of use to Esswood Campers. *[4 marks]*

(iv) Bar charts

Bar charts are visual representations of categorical data in which the height or width of the bars is used to show the values of the quantities measured. The bars are usually separated to signify that the data are not directly related or continuous.

Bar charts are used to give visual impact to data as well as allow for the comparison of data. For example, a firm might choose to use a bar chart to show its profit over time (to allow for historical comparisons) or to show its relative sales revenue in the industry (to allow for inter-firm comparisons).

Figure 50.2 shows that profits for Company X peaked at $330m in 2012 and plummeted to less than half of that value in 2020 when profits were $160m.

Figure 50.3 shows that Company A is the market leader with $600m worth of sales revenue, which is higher than any other firm in the market. By contrast, Company E is the smallest firm in the market, with the lowest value of sales revenue of $250 million.

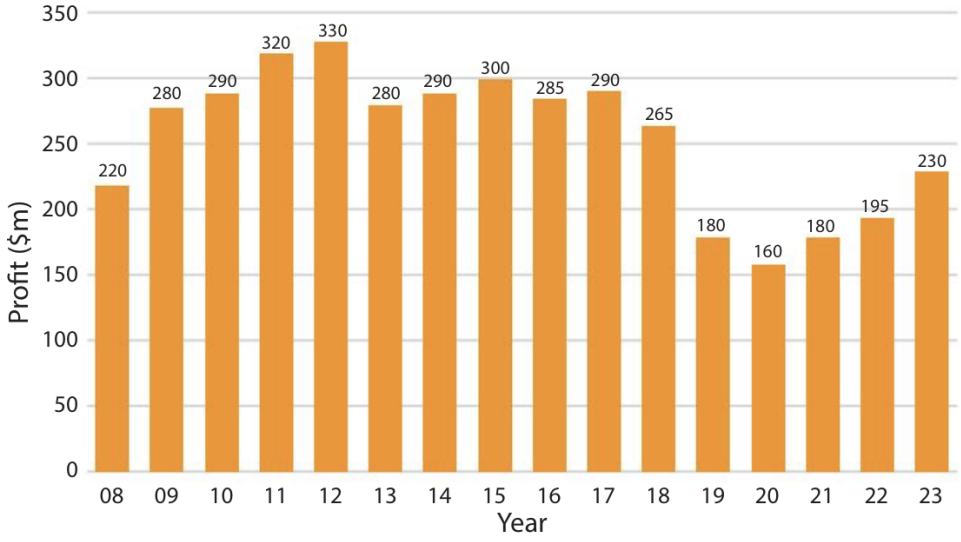


Figure 50.2 - Bar chart showing historical comparison of Company X's profits (2008 - 2023)

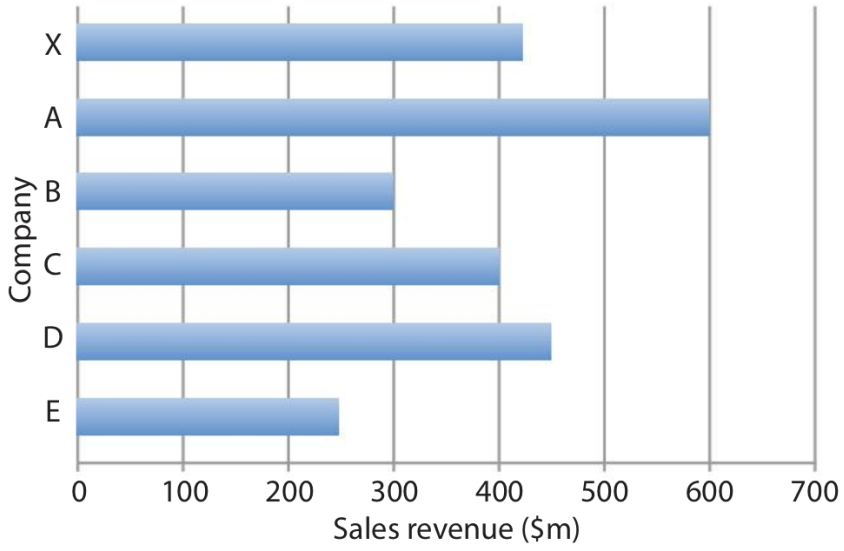


Figure 50.3 - Bar chart showing inter-firm comparisons of Company X's sales revenues (2023)

Question 50.3 - Chatterjee Travel Ltd.

Chatterjee Travel Ltd. is a London-based company that specialises in travel services for wealthy Finnish customers from around the world who are fanatics of The English Premier League (the world's most watched and lucrative sports league). Ira Chatterjee, the CEO, has built a wide customer base of wealthy clients who mainly fly from Finland, the Netherlands and Italy. Sales figures for the latter part of the football (soccer) season are shown below::

Sales	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**
(£'000)	30	28	32	35	30	0

(a) Outline why ChatterjeeTravel Ltd. might be described as operating in a niche market. *[2 marks]*

(b) Construct an appropriate graph to show the actual sales figures. *[3 marks]*

(c) Use your graph to explain how fluctuations in sales might affect ChatterjeeTravel Ltd. *[4 marks]*

(v) Pie charts

As its name suggests, a **pie chart** looks like a pie (or cake) and is a visual statistical graphical tool used to divide data sets into slices or segments to illustrate numerical proportions. This size of each segment is characterized by the angle at the centre of the pie and the arc length of each slice being proportional to the quantity it represents. For example, given there are 360 degrees in a complete circle, if we are trying to represent a quarter share, we will give it a quarter of the circle or 90 degrees.

Suppose a manufacturer of ice cream asked a random sample of 100 people to state their favourite flavour. The results of the survey are shown below:

Flavour of ice cream	Frequency
Coffee	12
Nutty	16
Raspberry	28
Strawberry	22
Vanilla	22
	100

To construct a pie chart to show these results, the calculations are shown below. Once these are determined, then the pie chart can be plotted (see Figure 50.4).

Flavour of ice cream	Calculation	Angle
Coffee	$(12 \div 100) \times 360^\circ = 43.2^\circ$	43
Nutty	$(16 \div 100) \times 360^\circ = 57.6^\circ$	58
Raspberry	$28 \div 100 \times 360^\circ = 100.8^\circ$	101
Strawberry	$22 \div 100 \times 360^\circ = 79.2^\circ$	79
Vanilla	$22 \div 100 \times 360^\circ = 79.2^\circ$	79
		360

Note: It may be that the rounded values of the angles do not always total 360°. In such cases, the largest angle should be adjusted.

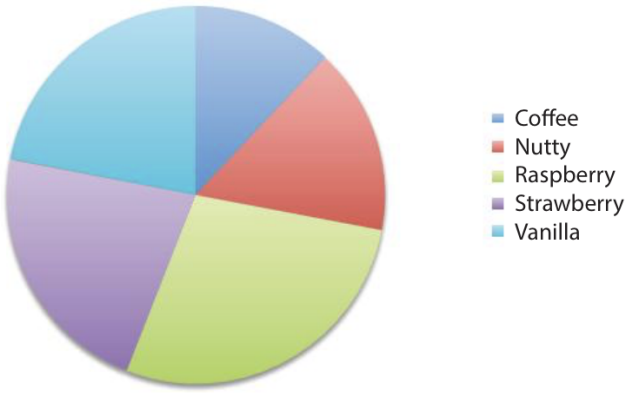


Figure 50.4 - Pie chart representing people's favourite flavour of ice cream

(vi) Infographics

Infographics are a type of visual tool used to show information using a combination of texts, images and graphics. They are used as visual representations of data. They are used to display data and information in an engaging and succinct way. This can help to communicate information in a striking and effective way to inform decision making.

The main purpose and advantage of using infographics is they can be a powerful tool to allow people to easily digest a vast amount of information, data and statistics through the creative use of visual charts and graphics. The main drawback however is the amount of time needed to create visually appealing infographics. This also requires expertise so can be costly.

(vii) Quartiles

A **quartile** divides a data set (such as a firm's sales revenue over the past 12 months) into four parts. Using quartiles enables managers to see the distribution of data such as the ranking of salespeople based on the value of sales revenue attributed to each employee. This method is an extension of the median average in order to support decision making.

If a business earns $100 million in sales, it is not immediately clear how good this is or whether the owners would declare this as a success. However, if this figure puts the business in the top quartile of firms in the industry, this number is more likely to please the owners. By contrast, if this figure puts the business in the bottom quartile, it is far less impressive.

In this simplistic data set, there are 5 values that have already been placed in numerical order:

1 2 3 4 5

- 1 is the smallest number in the data set and is called the *minimum* value.
- 5 is the largest number and is called the *maximum* value.
- 3 is the median, as discussed above.
- 2 is mid-way between the minimum value (1) and the median value (3), so falls into the lower quartile.
- 4 is mid-way between the median value (3) and the maximum value (5), so falls into the upper quartile.

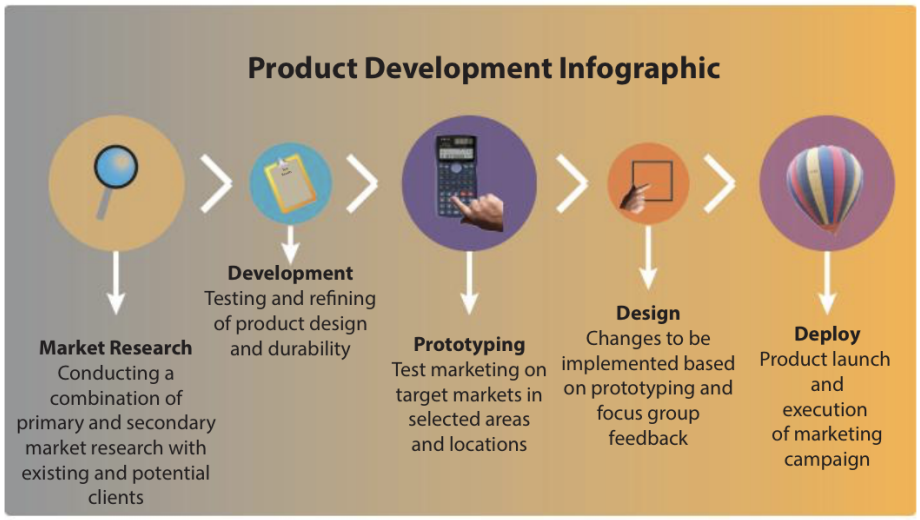


Figure 50.5 - Infographics use a combination of texts, images and graphics

Suppose there are 9 data items in the data set:

1 2 3 4 5 6 7 8 9

- 5 (red) is the median value.
- 3 (grey) is mid-way between the minimum value (1) and the median (5), so is in the lower quartile.
- 7 (green) is mid-way between the median value (5) and maximum value (9), so is in the upper quartile.

The five-point data summary is shown below:

- 16 is the lowest score
- 18 is the lower quartile
- 20 is the median
- 21 is the upper quartile
- 24 is the highest score

This can be represented diagrammatically as follows:

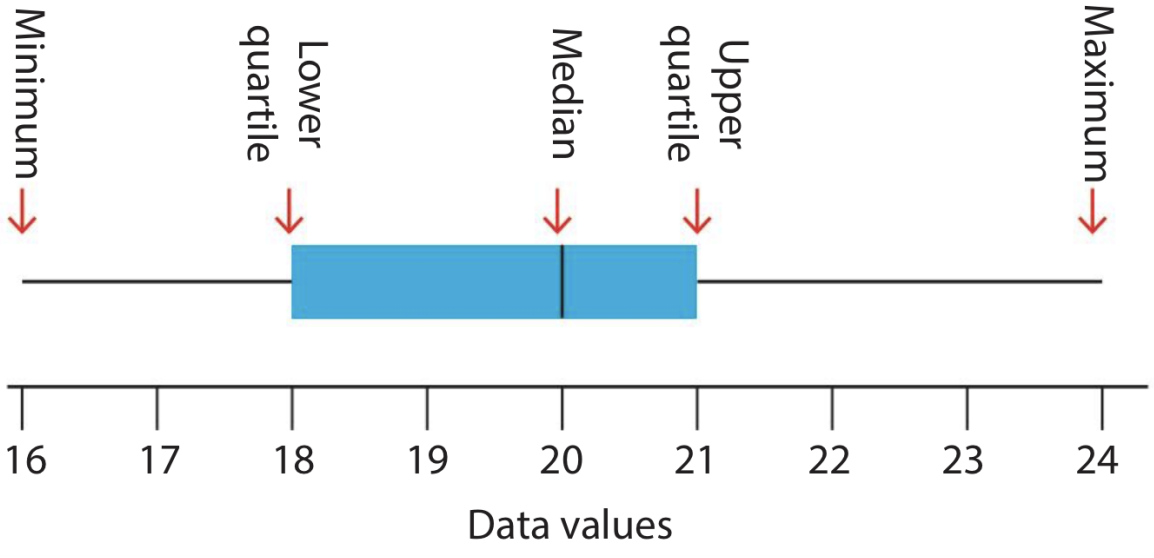
Take the example of a class with 19 students who have recently taken a test marked out of 25. The raw scores (marks) for these students are shown below:

18	17	18	21	21	24	20	20	20	18
22	20	20	16	21	19	21	19	18	

Once placed in order the data set looks like this:

16	17	18	18	18	18	19	19	20	**20**	20	20	21	21	21	21	21	22	24

From this diagram, it can be seen that the central value or median is 20 marks. It also shows the two measures of dispersion: (i) the range (16 to 24) and (ii) the inter-quartile range (18 to 21). The data can provide support for managers and decision makers. For example, students who achieved lower than the scores in the inter-quartile range for this assessment might need additional support prior to the final exams.



Splitting the data into quartiles enables manager to see the **interquartile range**. This is used to show the spread of data in a data set by calculating the difference between the first and third quartiles, thereby showing the middle spread of the data. Outliers are extreme values which are higher or lower than the interquartile range.

There are several ways in which a business can use quartiles as a business management tool, such as:

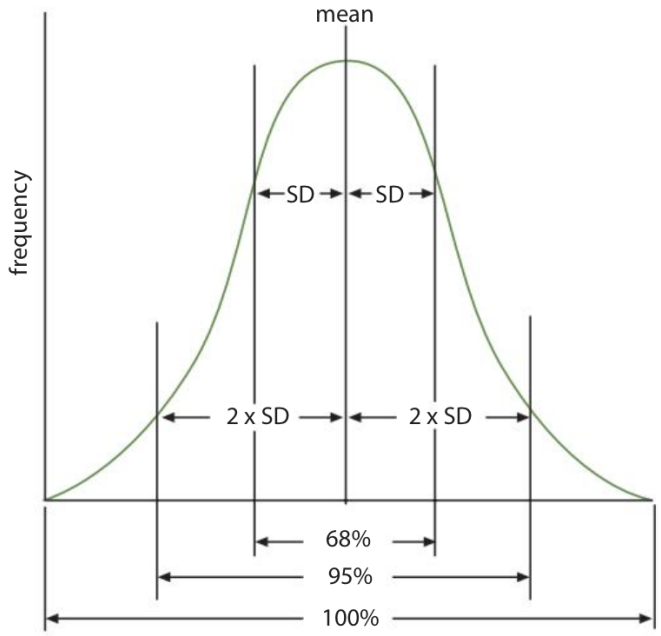
- Determining the relative rank of a business in terms of its sales, profits, market share or other quantitative measure.
- Deciding to give larger pay rises or bonuses to salespeople who are in the top quartile (top 25%) for sales.
- Providing additional training and/or performance reviews for workers who are underperforming (in the bottom quartile).

(viii) Standard deviation

The **standard deviation** is a statistical measure of the dispersion (or variation) of the values in a set of data around its mean (the arithmetic mean value). In other words, the standard deviation refers to the average distance from the mean value of all points in a data set. This means it shows whether there is a small or large spread of the results.

A lower standard deviation means that the measured values of a variable are distributed closer to the arithmetic mean. by contrast, a higher standard deviation means that the various points in a data set are more dispersed and deviate from the mean.

For most data sets, there is a normal distribution of the variables. in such cases, the general rule of thumb is that approximately 68% of all data points are spread from the mean within one (or the) standard deviation. Within two standard deviations, there is coverage of around 95 percent of all data points. Deviations higher than this average are referred to as outliers. Almost all the data will lie within 3 standard deviations either side of the mean.



(note: SD represents Standard Deviation)

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Question 50.4

The daily sales figures ($) for a small delicatessen over a period of 25 working days were:

400	428	415	482	379	448	434	417	451	465	428	419	417
415	447	425	460	452	465	424	427	385	450	449	421	

(a) Determine the median value. *[1 marks]*

(b) Calculate the mean value to 2 decimal places. *[2 marks]*

(c) Calculate the quartiles. *[3 marks]*

For example, suppose a survey of 100 employees reveals that they spend, on average, $5.50 per day on their lunch and that the standard deviation is $1. This means that the average distance of all 100 data points from the mean is $1. Hence, most employees (around 68% of them) will spend between $4.50 and $6.50 (+/- $1 from the arithmetic mean) each day. Around 95% of the employees will spend between $3.50 and $7.50 on their lunch (that is, +/- two times the standard deviation of $1).

The data below show the number of meals sold at a restaurant for the past 5 days.

Day	Meals sold
Mon	320
Tues	310
Wed	320
Thurs	360
Fri	405

To calculate the standard deviation (σ):

- Work out the mean average - In this case, it is the total sum of the meals sold during the past 5 days (1,715) divided by the number of days (5). So, the mean is 1,715 / 5 = 343 meals.
- Calculate the deviations of each data point from the arithmetic mean. For example, the deviation on Monday is 320 – 343 = -23 (i.e., on Monday, 23 fewer meals were sold compared to the mean for the five days).
- For each data point, square the difference from the mean. For example, for Monday, this -232 = 529.
- Finally, find the square root of the average of the squared deviations to determine the standard deviation. In this case, σ = √1,256 = **35.44** (or 35 meals).

Day	Meals sold	Mean	Deviation from mean	Squared deviation
Mon	320	343	-23	529
Tues	310	343	-33	1,089
Wed	320	343	-23	529
Thurs	360	343	17	289
Fri	405	343	62	3,844
Total	1,715		Average deviation	1,256
Mean	343		Standard deviation (σ)	35.44

CORE

Question 50.5

The numbers of vehicles sold per month by a car dealership over one year was: 19, 26, 20, 20, 15, 18, 20, 17, 21, 22, 19 and 14.

(a) Calculate the mean. *[2 marks]*

(b) Calculate the standard deviation of these data. *[3 marks]*

Exam tip !

The standard deviation is always expressed in the same unit of measurement as the variable in question. This makes the interpretation easier to comprehend.

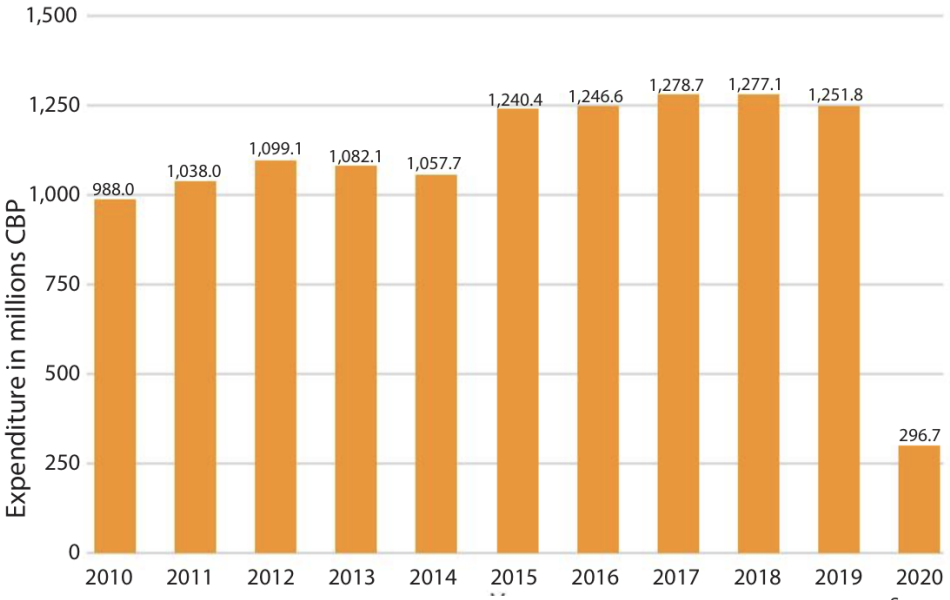
Exam tip !

Given that most new products fail to get established in the market, this implies that businesses often over-predict their sales, i.e., sales forecasting (Chapter 25) is not an exact science. Therefore, you need to be aware of the limitations of quantitative methods such as sales forecasting and standard deviations.

Evaluating descriptive statistics

In practice, businesses are likely to use a combination of descriptive statistics methods. The choice depends on several factors, such as:

- Accuracy (how accurate do the forecasts need to be?) - The greater the degree of certainty needed, the more thorough the methods of descriptive statistics need to be. For example, it is more meaningful to include actual figures on bar charts or actual percentage figures on a pie chart. Using the mode to express average month sales figures might not reveal large seasonal fluctuations in demand for certain products. Infographics can display data and information in an engaging way, but they are often open to interpretation because images, graphs and charts do not always reveal the whole picture, nor do they necessarily include any context. Of course, the greater the level of accuracy needed, the more time and money this is likely to involve.
- Time (how far back does the data go and how relevant is the information today?) - Descriptive statistics do not necessarily reveal any dialogue or context behind the data, which can easily become out of date by the time they are published. Consider the graph below, as an example, which shows the box office sales revenue of cinemas in the UK. On its own, the chart does not explain or suggest any reason for the huge fall in sales revenues during 2020. Further research will show that all cinemas in the UK went into lockdown for many months during the COVID-19 pandemic and some remained closed until May 2021.
- Cost (the availability and cost of data and information collection) - If there is widespread access to a wealth of information at no or very little cost, then this can make the collection and presentation of descriptive statistics more accurate. However, if it proves difficult to find appropriate and up-to-date information or if access to information is highly expensive, this will affect the choice of the method(s) used.



Source: Adapted from Statista

Exam tip!

When analysing or interpreting data and statistics, critically think about how reliable these might be. Consider whether there might a 'hidden agenda' behind the figures, such as the possibility of window dressing to make a company's final accounts more appealing (see Chapter 17).

REVIEW QUESTIONS

1. What is the meaning of descriptive statistics?
2. What is the mean (also known as the arithmetic mean)?
3. What is the mode (also known as the modal average)?
4. What is meant by the median (also referred to as the median average)?
5. What are bar charts used to show?
6. What are pie charts?
7. What are infographics?
8. What are quartiles and how are they calculated
9. What is meant by standard deviation and how is it calculated?
10. What are the potential limitations of using descriptive statistics to aid business decision-making?

KEY TERMS

Bar charts are visual representations of categorical data in which the height or width of the bars is used to show the values of the quantities measured. The bars usually separated to signify that the data are not directly related or continuous.

Descriptive statistics refer to the various tools used to summarize statistical data in order to help managers and decision makers to analyse their significance and to support their decision-making.

Infographics are a type of visual tool used to show information using a combination of texts and graphics.

The **interquartile range** is a statistical tool used to show the spread of data by calculating the difference between the first and third quartiles, thereby showing the middle spread of the data.

The **mean** (or **arithmetic mean**) is the most common of the three measures of an average, found by dividing the sum of all the numbers in a data set by the total number of items in that data set.

The **median** (or **median average**) in a data set refers to the middle number when all items are ranked in numerical order.

The **mode** (or **modal average**) is the number that occurs more frequently than any other value in a data set.

A **pie chart** is a visual statistical graphical tool used to divide data sets into slices or segments to illustrate numerical proportions. This size of each segment is characterized by the angle at the centre of the pie and the arc length of each slice being proportional to the quantity it represents.

A **quartile** divides a data set into four parts, enabling managers to see the distribution of the data set.

The **standard deviation** refers to the average distance from the mean value of all points in a data set, i.e., it measures by how much these points deviate from the arithmetic mean value.

Chapter 51
Business Management Toolkit (BMT) 8 - Circular business models

"The secret of happiness, you see, is not found in seeking more, but in developing the capacity to enjoy less."
- Socrates (c.410 BC - 399 BC), Greek philosopher

Circular business models

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. Circular business models are a type of decision-making tool. The syllabus specifies five circular business models as part of the toolkit: (i) circular supply models, (ii) resource recovery models, (iii) product life extension models, (iv) sharing models and (v) product service system models.

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A growing trend in the world of business is the move away from traditional business models of single-use resources and products (which are then discarded as waste) towards circular business models that enable materials and products to be reused and remain in the economy for as long as possible.

Traditional business models are only concerned about the financial costs of using resources, such as beverage companies that continue to use plastics which are cheaper than glass, so they can generate a profit for shareholders and business owners. They focus on producing, selling, using and throwing away products, without much if any consideration of the environmental impacts of business activities or what happens to these products once they have been bought and consumed, including how the packaging is disposed of.

These models, also known as **linear business models,** do not consider the long-term environmental impacts of business activities (see Figure 51.1) Linear business models have created a **disposable society** in which consumers replace or upgrade products (such as smartphones, laptops, cars and items of clothing) simply because they are no longer interested in them rather than the actual need to change these things. However, there is greater societal awareness and concern about issues such as carbon emissions, the unsustainable use of fossil fuels, climate change, global warming and a disposable society (see Case study 51.1) in which goods are replaced much earlier than their expected life cycle.

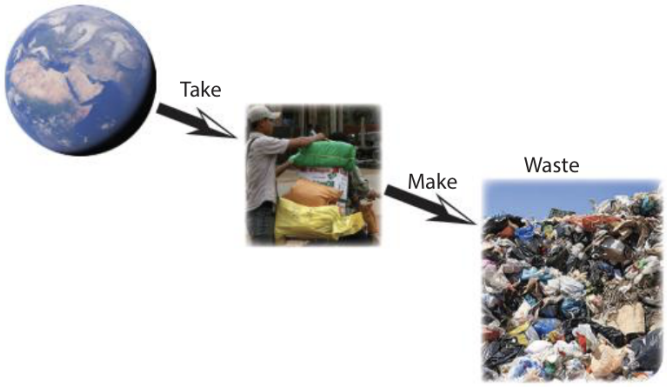

Figure 51.1 - Interpretation of traditional, linear business models

By contrast, **circular business models** (CBMs) are decision-making tools that focus on the environmental impacts of business activities. CBMs also emphasize sustainability matters related to all aspects of a firm's operations. These models contrast with traditional business models that focus on costs, revenues and profits. Instead, CBMs enable businesses to reduce, reuse, repair and recycle waste in order to support the shift towards circularity (see Figure 51.2). CBMs focus on the key business activities required to transition to a more resource efficient and

sustainable circular economy, such as the widespread adoption of renewable energy.

The Organization for Economic Cooperation and Development (OECD) defines circular business models as frameworks that "*represent fundamentally different ways of producing and consuming goods and services. They have the potential to drive the transition towards a more resource efficient and circular economy and in doing so, significantly reduce the environmental pressure resulting from economic activity.*" Hence, circular business models enable materials and products to be reused and remain in the economy for as long as possible.

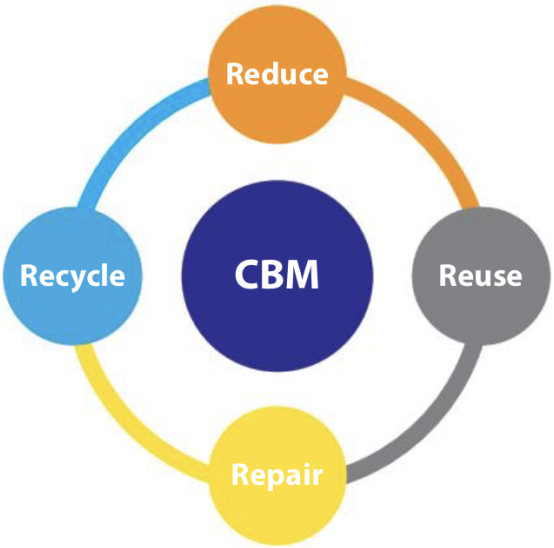

Figure 51.2 - Typical circular business models (CBM) focus on the 4 Rs: reduce, reuse, repair and recycle

Advantages of using circular business models include:

- Offering new commercial opportunities for businesses.
- Contributing to sustainable business growth.
- Generating new revenue streams.
- Transforming an organization's relationship with its customers, suppliers, local communities and governments.
- Attracting investors seeking to support businesses that act in a socially responsible way towards the natural environment and ecosystems.
- Protecting the natural environment and ecosystems that we all rely on.
- Avoiding negative media coverage or criticism (bad publicity).
- Safeguarding the economy against resource depletion, supply shortages and the rising cost of raw materials.
- Gaining a competitive advantage over rival businesses that do not adopt circularity.

All circular business models develop an approach where materials and resources used in all aspects of business operations are continually cycled back into the production process (see Figure 51.3), thereby resulting in greater efficiency, less waste, as well as a reduction in energy and resource consumption. Ultimately, CBMs safeguard the economy against resource depletion, supply shortages and the rising costs of raw materials for a sustainable future.

Case study 51.1 - Fast Fashion



In the textiles industry, fast fashion is a business model based on offering customers fashionable clothes at affordable prices. However, this generates a huge amount of textile waste as fashions and trends change so quickly in the industry. Adopting a circular business model could involve:

- ensuring the longevity and durability of clothing items
- renting and leasing clothes, rather than buying them
- creating facilities for selling and/or donating second-hand clothes for resale
- recycling and reusing textile materials.

CORE

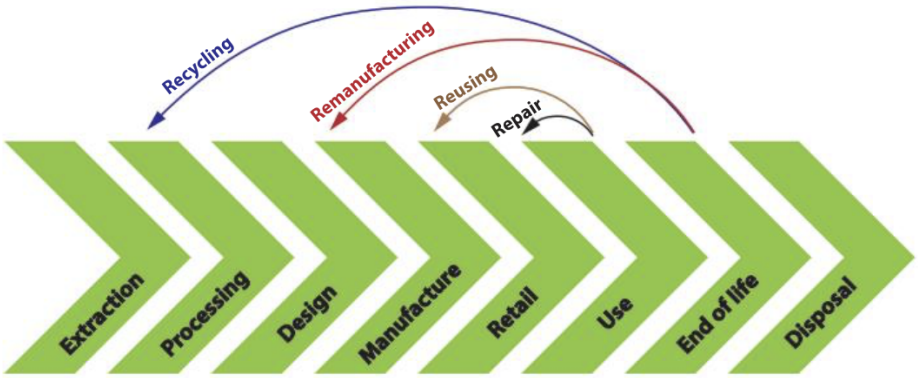

Figure 51.3 - Illustration of the circular supply model

The IB syllabus specifies the five CBMs used by the OECD: (i) circular supply models, (ii) resource recovery models, (iii) product life extension models, (iv) sharing models and (v) product service system models. They are called circular business models because they are designed to turn all waste that businesses and consumers generate into useful and valuable resources that can be used again in a sustainable way.

Common mistake

Students often claim that circular business models are simply about reducing the amount of waste in landfills and encouraging the recycling of trash such as wastepaper and plastics. Whilst these activities are part of a circular economy, CBMs cover a much broader range of activities (see the five CBMs covered in the remainder of this Chapter).

1 Circular supply models

Circular supply models are CBMs that focus on replacing finite natural resources with renewable, recyclable and biodegradable resources in a sustainable way. The use of these scarce resources applies to the production process as well as all other areas of business activity.

Unlike a linear business model, the circular supply model requires businesses to develop new and more efficient uses of waste as resource inputs, thereby reducing society's reliance on finite and non-renewable and extracted natural resources such as fossil fuels. Instead, businesses use bio-based, renewable, and/or recovered materials in a sustainable yet profitable manner. For example, science-based companies have developed ways to convert agricultural residue (such as bales, husks, leaves and stalks) into renewable fuel. For example, Veolia, a French multinational company, burns poultry litter and scrap wood to turn into electricity. Veolia uses a circular supply model for all three aspects of its operations - water management, waste management and energy services.



Figure 51.4 - Straw bales in cornfields used as part of circular supplies

The circular supply model, as with all the other types of CBMs, allows businesses to reduce the harmful impacts of their operations on the natural environment and work on a more sustainable basis. As the earth's resources dwindle, they become more expensive, so adopting a circular supply model can help businesses to remain viable. Hence, in the long run, it can be more profitable for businesses to adopt a circular supply approach to resource use and waste management.

2 Resource recovery models

Resource recovery models are a circular business model that aim to re-use (or 'recover') resource outputs by re-processing waste materials (such as glass, plastics and metals) into new and usable resources. They emphasise technological innovations and the use of facilities to recover and reuse resource outputs thereby eliminating material waste and putting less pressure on the use of the earth's scarce resources. Examples of resource recovery models include:

- Cradle-to-cradle (C2C) design and manufacturing, whereby waste materials at the end of the product life cycle are re-processed into new resources.
- Closed-loop recycling, which involves processes to collect, recycle and reproduce waste to make something new (see Figure 51.5).
- Industrial symbiosis, which is the process of turning waste products or by-products of one industry into raw materials for another industry.



Figure 51.5 - The closed-loop recycling model

The advantages of using resource recovery models include:

- Preservation of the planet's finite and natural resources.
- Minimizing the risks associated with damage to the environment, including wildlife, oceans and ecosystems.
- Saving landfill space reserved for waste that has no recycling option.
- Reducing pollution on the land, in the waters and in the air.

Essentially, resource recovery models turn waste into a reusable resource without having any negative impact on the environment. For example, according to the OECD, supplying raw materials by way of recycling, instead of from non-renewable natural resources, can reduce greenhouse gas emissions by as much as 90%.

3 Product life extension models

Product life extension models are circular business models based on businesses extending the life cycle of their products in order to reduce the use of the finite resources needed to produce them. By extending the lifespan of their products for as long as possible, businesses can prevent products being thrown away as well as reduce the need to use even more scarce resources in the production process. For example, Caterpillar, the world's largest construction-equipment manufacturer, remanufacturers engine parts and other components, returning used parts to like-new condition. Customers get the same quality, warranty, performance and reliability at a fraction of the price of a new version of the second life product.



Figure 51.6 - Caterpillar is the world's largest producer of construction machinery

Rather than throwing away materials or allowing them to become waste, product life extension models seek to maintain or improve the durability of manufactured products. This could include designing products, such as laptops and smartphones, so that they are easier to repair and upgrade without having to replace them entirely. The models could also include designing and manufacturing products to enable customers to repair these items more easily for themselves. For example, at the

end of 2021, Apple announced the launch of its "Self Service Repair", which enables customers to do their own repairs to their iPhones and Mac computers using genuine Apple parts and tools.

According to the OECD, product life extension models that remanufacture products that have reached the end of their product life cycle can reduce the extraction of natural resources and the generation of waste by up to 80% compared with manufacturing completely new products. Examples include the refurbishment of smartphones, remanufacturing motor cars and remanufacturing consumer electrical products. Extending the life span of products by remanufacturing them also enables businesses to compete with new products from low-cost, low-quality rival producers. The reduced extraction, processing and transportation of natural resources also translates into energy savings for businesses.

Another major advantage for businesses adopting product life extension models is that durability (longevity) of products can be a key competitive differentiator. This can help to give the firms a unique or distinctive selling point (see Chapter 24) and competitive advantage (see Chapter 53). Successful product differentiation also enables businesses to charge premium prices (see Chapter 28), meaning that CBM can raise profit margins.

4 Sharing models

Sharing models are a type of circular business model that places emphasis on offering services where customers share products rather than owning such items for themselves. These models rely on the sharing of products that would otherwise have a low ownership and/or usage rate. Examples of businesses that use sharing models include:

- Airbnb, the world's largest provider of short-term rental accommodation, does not own any real estate. Instead, the online company relies on existing properties being shared rather than new hotels and accommodations needing to be built.
- Uber, the world's largest taxi service provider, does not own any motor vehicles. Instead, Uber drivers use their own existing vehicles to provide taxi services.
- Car-sharing services, such as ZipCar, where members pay a monthly fee in addition to car reservations charges without the inconveniences associated with private car ownership.
- Service providers that allow their members to receive a set of re-used and age-appropriate toys, books, board games and puzzles. Each month, the service provider swaps these for another set of items that have been thoroughly cleaned and hand-picked for another subscriber. This type of sharing model enables parents (as customers) to reduce clutter and litter, as well as to save money.

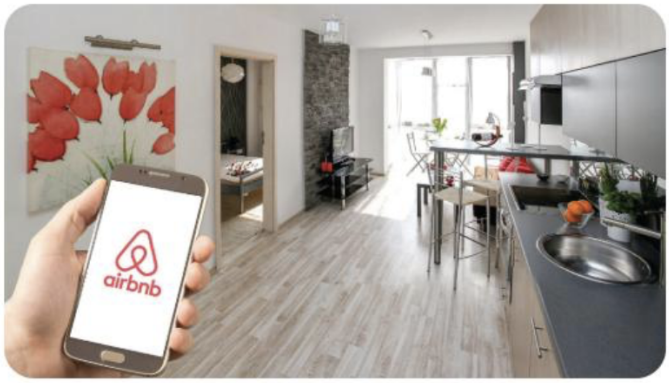

Figure 51.7 - Airbnb uses a sharing circular business model

The main benefits of sharing models, in line with all circular business models, include:

- Facilitating the sharing of under-used products, so that such products are used more fully. For example, many car owners only use their private vehicles for perhaps 1 or 2 hours a day at most.
- Reducing the demand for new products and therefore the resources and raw materials needed to produce these, helps to conserve the planet's finite resources.
- The sharing of already existing products also reduces environmental burdens, such as excess garbage and packaging waste.
- Ultimately, sharing circular business models help to create a more sustainable future as well as a greener and cleaner world.

The continual advances in Internet and mobile technologies as well as the development of customer referral and online review systems have enabled far more products to be shared than ever before. This trend is only likely to continue into the future as sustainability gains prominence in all business sectors across the world.

5 Product service system models

A **product service system model** (also called **servitization**) is based on the premise that businesses offer the *function* of a product rather than the physical *product* itself. Such models focus on the underlying needs of consumers, who do not necessarily want to own the product, but want to benefit from using it. These models allow customers to lease or rent products rather than buy them outright. The business has legal ownership rights and rents out the asset to customers, thereby keeping the product in use for longer. In other words, it is not about selling a physical good, but the service from the product that customers seek. These models use a pay-for-use arrangement with the service provider rather than the conventional buy-to-own approach. Examples include:

- Online music streaming services, such as iTunes and Spotify, rather than consumers owning CDs and vinyl records.
- Multimedia streaming services, such as Netflix, Disney+ and Amazon Prime, instead of customers purchasing DVDs and DVD players.
- Cloud file hosting and storage service providers, such as iCloud, Google Drive and Dropbox, have reduced the need for physical computers and laptops with large storage devices, including external hard drives and hardware accessories.
- Michelin, one of the world's largest tyre manufacturers, sells tyres as a service rather than a physical product to business customers, who pay for the miles driven. Customers do not own the tyres, but they aren't responsible for any maintenance either. This model gives Michelin an incentive to design and develop longer lasting tyres as well as tyres that can be repaired and recycled more easily.
- Air conditioning manufacturers lease out their equipment, saving businesses installation, repair and replacement costs. When the time comes, the service provider takes the equipment back for appropriate reuse, repair, recycling or environmentally friendly waste disposal.

Case study 51.2 - Working online

Communications technology platforms, such as Skype, Teams, Meet and Zoom and cloud-based software platforms have changed the way in which many businesses and multinational companies around the world operate without the need for people to travel thereby reducing our carbon footprint. Examples include:

- Conducting business meetings via teleconferencing applications
- Recruitment via online job interviews
- Enabling people to work from home (WFH).



Technological advances have enabled more people to work from home

Product service system models create incentives for businesses to use environmentally friendly product designs and more efficient product use. Hence, as CBMs, they help to promote a greener and more sparing approach to resource use, especially with non-renewable natural resources.

Evaluation of circular business models

Environmental protection, including the natural environment and ecosystems that societies rely upon. Adopting circular business models helps to reduce the environmental footprint of production and consumption. Businesses can therefore align themselves better with individuals and societies demanding the use of cleaner technologies and less damage to the planet. This is important for the sustainability of all businesses across all industries in the long term.

Circular business models, such as circular supply models and resource recovery models, show that businesses can thrive in a sustainable way without the dependence on finding and extracting new, finite and non-renewable resources. By contrast, **green technologies** are environmentally friendly innovations that consider the long-term impact on the environment, such as renewable energy sources such as solar panels and wind turbines. By using fewer non-renewable resources and focusing more on the use of greener technologies, businesses can also cut their costs of production in the long term.



Figure 51.8 - Solar power are a type of green technologies

Adopting circular business models enables a business to act in a socially responsible way, which also helps to improve the firm's corporate image. Doing so also helps to improve an organization's relationship with its key stakeholder groups, such as employees, customers, investors, environmental pressure groups and the local community. Corporate social responsibility (CSR) and CBMs go hand in hand, which can also help to attract and retain skilled and loyal employees because an increasing number of people are more concerned about the environmental aspects of the organization in which they work.

However, there are limitations of adopting circular business models. First, changing to a circular business model can be highly expensive, especially in the short term. The traditional, linear business model (produce, sell, use and throw away) is often significantly cheaper for a business than adopting a circular business model. This is one reason why Coca-Cola, the world's largest plastic polluter, uses plastic bottles for its drinks rather than glass bottles. The higher costs mean that businesses would need to attract customers who are willing to pay more for expensive albeit greener and environmentally friendlier products.

Secondly, implementing a CBM will require businesses to gives up some of the economies of scale (see Chapter 5) gained from large-scale operations and to reduce the degree of specialization and sophistication of their products. However, consumers might not be willing to forego product quality and performance in the short run for environmental sustainability in the long run.



Figure 51.9 - Environmental sustainability puts the planet before profits

Furthermore, without government intervention, it can be challenging for any business to authentically adopt a circular business model. The OECD states that governments need to address issues such as the mispricing of natural resources that are often under-priced and therefore over produced due to the provision of subsidies for businesses in extractive industries. Trade policies of different governments often restrict cross-border flows of goods and services, thereby limiting the ability of businesses to achieve a circular approach. Without sufficient government support, unemployment may rise in some industries, particularly in manufacturing, as a result of businesses adopting circular business models.

Nevertheless, adopting circular business models can ultimately give organizations competitive advantages and facilitate their operations in a socially responsible and sustainable manner, benefiting individuals organizations and societies.

Exam tip !

Despite there being five prescribed circular business models in the syllabus, it is not always straightforward to categorize businesses or their operations under these categories. For example, bike sharing services offered in city centres across the world have characteristics of both a sharing model and a product service system model. The important thing for you to remember is the need to fully justify your lines of reasoning.

Question 51.1 - McDonald's

In 1991, McDonald's became the world's first company to voluntarily phase out the use of chlorofluorocarbons (CFCs) in the production of foam packaging. CFCs were associated with ozone depletion, so their withdrawal by the world's largest restaurant chain helped to reduce the harmful effects on the ozone layer. In 2018, the company announced it would phase out the use of plastic straws.

As part of its strategic move to adopt a **circular business model,** McDonald's opened its very first net-zero carbon restaurant in the UK in December 2021. The restaurant in Market Drayton, Shropshire, was built using natural and recycled materials and is powered by a combination of wind turbines and solar panels.

(a) Define the term *circular business model.* *[2 marks]*

(b) Explain **two** reasons why a business such as McDonald's might choose to move away from a traditional business model to a circular business model. *[4 marks]*

CORE

Question 51.2 - Second Chance Bangkok

Second Chance Bangkok is a **social enterprise** established to improve the lives of local people in one of the poorest parts of Bangkok, Thailand's capital city. The idea behind Second Chance Bangkok was a local initiative created by local residents of Bangkok's largest slum, Klong Toey. The organization has a workforce of 16 employees. The organization uses a circular business model and emphasises "people before profits" and operates by its mantra of "Recycle, Reuse, Renew" as well as emphasis on upcycling (the creative reuse of existing and unwanted products).



Image reproduced with permission of Second Chance Bangkok https://www.scbkk.org/

As a social enterprise, Second Chance Bangkok focuses on the below-the-line promotional strategies that the charity should use to increase sales revenues from its small shop that sells recycled and upcycled products such as purses, headbands and ties. It also relies on the use of social media marketing to gain greater exposure. Second Chance Bangkok also faces cash flow problems especially during off peak seasons when tourist numbers drop.

(a) Define the term *social enterprise.* *[2 marks]*

(b) Distinguish between traditional (linear) and circular business models. *[4 marks]*

(c) Explain **two** benefits for Second Chance Bangkok of using a circular business model. *[4 marks]*

Theory of Knowledge (TOK)

State the ten traits of the IB Learner Profile. To what extent does the IB Learner Profile promote **sustainability**?

ATL Activity (Thinking skills)

Discuss the extent to which the activities of multinational companies (see Chapter 6) are a hinderance to the circular economy.

Business Management Toolkit

Discuss how adopting circular business models could be seen as either an opportunity for businesses or a potential threat.

Key concept

Aside from **sustainability,** which of the key concepts is most important to the study of circular business models - **change**, **ethics** or **creativity**?

Key concept

Discuss how **ethical** business behaviour contributes to the **sustainability** of business organizations.

REVIEW QUESTIONS

1. What is meant by a traditional or linear business model?
2. What is a disposable society?
3. What are circular business models?
4. What are circular supply models?
5. What are resource recovery models?
6. What are product life extension models?
7. What are sharing models?
8. What are product service system models (also known as servatization)?
9. What are the main benefits of adopting circular business models?
10. What are the main limitations or drawbacks of using circular business models?

KEY TERMS

Circular business models (CBMs) are decision making tools that emphasize the environmental consequences and sustainability matters related to all aspects of business activities. It contrasts with traditional business models that focus on costs, revenues and profits. CBMs enable businesses to reduce, reuse and recycle waste.

Circular supply models are CBMs that focus on replacing finite natural resources with renewable, recyclable and biodegradable resources in a sustainable way.

A **disposable society** is the result of traditional business model whereby consumers replace or upgrade products because they are bored of them rather than the actual need to change these things.

Product life extension models are circular business models based on businesses extending the life span of their products to reduce the use of the finite resources needed to replace them.

Product service system models (or **servatization**) are circular business models based on the premise that businesses provide a service rather than a physical good, thereby limiting waste and the need for more productive resources.

Resource recovery models are circular business models that emphasise technological innovations and facilities to retrieve and reuse resource outputs, thereby eliminating material waste.

Sharing models are a type of circular business model that places emphasis on offering services where customers share products rather than owning such items for themselves.

The **traditional** (or **linear**) **business model** focuses on producing, selling, using and throwing away products, without much if any consideration of the environmental impacts of business activities.



Figure 51.11 - The linear business model does not focus on waste management

Chapter 52
Business Management Toolkit (BMT) 9 - Gantt charts (HL only)

HIGHER LEVEL

"For tomorrow belongs to the people who prepare for it today."
- Malcolm X (1925 - 1965), African American human rights activist

Gantt charts

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. Gantt charts are a type of planning tool.

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A **Gantt chart** is a visual business management tool used to plan and schedule projects. It is a representation of all the tasks in a particular project plotted against the timescale, allowing project managers and decision makers to identify the shortest amount of time needed to complete a particular project. The tool was created around 1910 by Henry L. Gantt (1861-1919), an American mechanical engineer.

The tool was designed to help supervisors see whether factory workers were on target in meeting deadlines for manufactured output. Essentially, Gantt charts show the quickest time in which projects can be completed if tasks are sufficiently well-planned and carried out efficiently.



Figure 52.1 – The use of Gantt charts helps business projects to finish on time

Project management allows managers to complete a project successfully in the quickest time available by overseeing a large number of activities and ensuring that each task is completed on schedule, in a similar way to critical path analysis (see Chapter 56). If a deadline is missed, there is likely to be delays for the rest of the project. Late completion of a project or the late delivery of output to a client can be very costly to the business. Gantt charts show this information visually, giving project managers an instant overview of the project, the activities involved, their duration and when each individual activity in a project needs to be finished.

The rules used to construct and interpret Gantt charts are as follows:

- It is presented as a bar chart showing all the scheduled tasks for a project over a given time scale.
- The time scale is shown on the horizontal axis.
- Each activity is shown by a separate horizontal rectangular bar, with the length depicting the duration of the activity.
- Each horizontal bar shows the start date, duration and end date of an activity.
- Both critical and non-critical activities (those with some slack time) are shown.
- Predecessor-successor relationships are shown, i.e. activities that must be preceded by others and activities that must follow others.

HIGHER LEVEL

The ultimate purpose of producing a Gantt chart is to identify the minimum (shortest) amount of time needed to complete a project. This requires the various tasks of a project to be planned in a logical order so that the different processes are completed with minimal delay and maximum efficiency. The process involves:

- Identifying all the activities required for the completion of the project.
- Breaking down the project into separate and clearly identifiable tasks.
- Determining how long each of these tasks will take.
- Identifying all **dependencies**, i.e., activities that cannot start until the completion of other preceding tasks. Arrows can be added to connect activities to show dependencies.
- Determining which tasks can take place concurrently (to minimize production time).
- Placing all tasks in the right sequence on the Gantt chart.

In reality, project managers tend to use computer software to generate Gantt charts, such as Microsoft Project, Microsoft Excel, Google Sheets and Microsoft Visio.

Consider the following simplified example which involves planning a graduation party. Assume that the date for the party has already been set.

Without using a Gantt chart, the individual tasks would take a total of 24 days. However, the Gantt chart in Figure 52.2 shows that the project can be completed 5 days quicker, in just 19 days.

Task	Description	Preceded by	Duration (days)
A	Send out invites and wait for replies	-	7
B	Research and book suitable venue based on number of replies	Task A	2
C	Book entertainment (music and awards ceremony)	Task B	5
D	Order food and drinks for delivery	Task B	7
E	Set up venue, dance floor and stage for the party	Tasks C & D	3

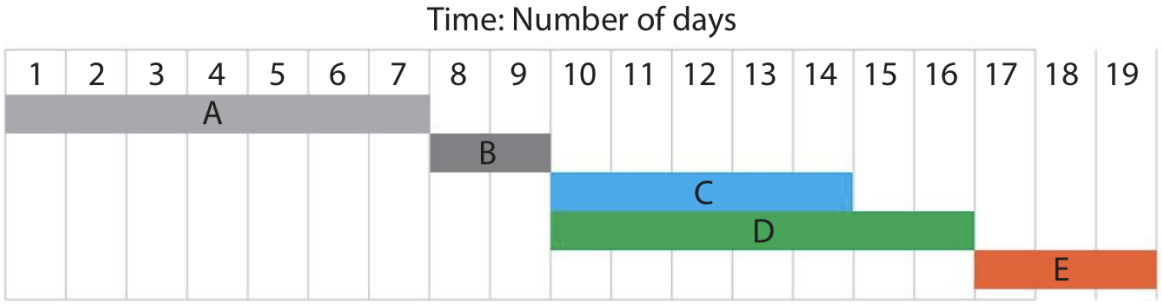

Figure 52.2 - Gantt chart for graduation party

- Task A takes 7 days to complete. So, the earliest time that activity B can start is after the 7th day.
- Task B takes 2 days to complete. So, activities C and D cannot start until after the 9th day.
- Task C starts after day 9 with a duration of 5 days, so it is completed on the 14th day at the earliest.
- Activity D can take place at the same time as Task C, but takes 7 days.
- Although task C can be finished by the 14th day, task E cannot start until activity D is also completed. Hence, completion of task C can be slightly delayed (by 2 days) without there being a delay to the overall project.
- Task E can only start when both tasks C and D are completed. Since task D starts on the 9th day and lasts 7 days, it will be completed on the 16th day after which task E can be started.
- Task E takes a further 3 days to complete, so the shortest time the project can be completed is 19 days.

ATL Activity 52.1 (Thinking and Self-Management skills)

Gantt charts present problems for many students, but you can get around these by practising the construction of the charts. As a practical exercise to reinforce your knowledge and understanding of this planning tool, create a Gantt chart for your Business Management Internal Assessment.

The following illustrative example shows a Gantt for the Internal Assessment (SL and HL), which is a research project that requires you to apply appropriate business management tools, theories and techniques to a real-world organizational issue or problem using a conceptual lens (creativity ethics, change or sustainability).

Note that although the below example is expressed in weeks, the internal assessment should be completed in approximately 20 hours as per the IB's recommendation. Also note the task H suggests that you can actually proofread your IA after submitting the first draft and before you receive feedback - the interim time period is not an opportunity to ignore changes and improvements that you can make, independent of your teacher's feedback. Task E also suggests that you should compile your bibliography throughout the research project - do not leave this until the very end and it will be more time consuming and inefficient to do so.

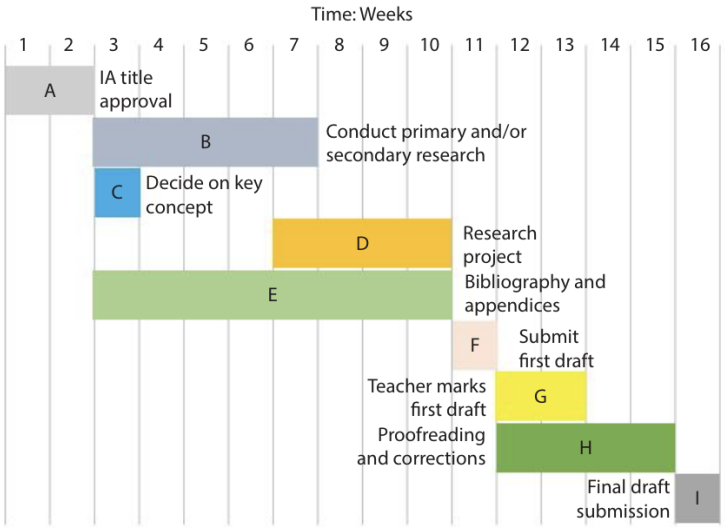

Figure 52.3 - Gantt chart for the Business Management IA

Question 52.1 - Project X

Construct a Gantt chart from the information below for Project X and identify the shortest time in which the project can be finished. *[5 marks]*

Task	Order (preceded by)	Estimated time (weeks)
A	-	3
B	-	3
C	-	3
D	A	2
E	B	4
F	C	1
G	D, E and F	6

HIGHER LEVEL

Question 52.2 - Kekerovic Construction

Kekerovic Contractors KC) specialises in the planning and construction of homes in Nîmes, southern France. The operations director, Bronco Kekerovic, has recently taken on a project to extend a five-bedroom home with an outdoor swimming pool. The tasks, duration and sequence of the project are shown below.



- A – Lay new foundation to the house: 1 week.
- B – Extension work on the existing house: 6 weeks. B is preceded by A.
- C – Excavation and foundation for the swimming pool: 2 weeks. C is preceded by A.
- D – Tiling and sealing of pool: 2 weeks. D is preceded by C.
- E – Internal décor and fixtures for the house: 3 weeks. E is preceded by B.
- F – Final testing and handing keys to the owner: 1 week. F is preceded by D and E.

(a) Construct a Gantt chart for Kekerovic Construction using the above information and identify the quickest time in which the project can be completed. *[4 marks]*

(b) Examine why the use of Gantt charts can be important for businesses such as Kekerovic Construction. *[6 marks]*

Exam tip !

You may be required to construct a Gantt chart from given information in the exams. This tool can be very challenging for a lot of students, so the only way to improve is by practising your technique. Even if your Gantt chart is slightly wrong, marks are awarded for correctly interpreting and explaining the diagram.

Theory of Knowledge (TOK)

Should **intuition** (gut feelings, hunches and/or instinct) play a more significant role than **scientific** (or quantitative) techniques in business decision-making?

Key concept

Discuss the extent to which it is possible for business decision-making to be simultaneously **creative** and **ethical**.

Theory of Knowledge (TOK)

As with all quantitative techniques, the value of Gantt charts depends on the underlying data collected and used.

To what extent do quantitative data reveal as much as they conceal?

Evaluation of Gantt charts

Advantages of Gantt charts

- Use of the tool enables project managers to monitor progress of large projects in an efficient way. Gantt charts provide an overall of a project and its timeline, enabling managers to appropriate finance and resources appropriately for each task.

- They make complex information more manageable, especially as a Gantt chart is presented as a visual planning tool. This helps to simplify a complex set of tasks within a large project. This helps team members to remain focused and to avoid being overwhelmed by the large number of tasks in the project.

- They improve efficiency by avoiding overlapping tasks and showing dependencies. A Gantt chart clearly shows how the beginning of one task can be dependent on the completion of other preceding tasks. That allows project managers to schedule tasks appropriately and to provide the right resources for each task to ensure it completes on time.

- They enable managers to set realistic deadlines and expectations of their teams. A Gantt chart illustrates all the tasks that must be accomplished in order to realistically complete a project on time. Consequently, having access to such information allows managers to set realistic expectations and deadlines for each task for each team, as well as for the project as a whole.

- They can be motivational as team members can visualize the various tasks they are responsible for, thereby motivating them to complete their work on time so as to not delay the project. Team members can see the progress they contribute to the overall project, creating a sense of value to the organization.

Limitations of Gantt charts

- For larger and more complex projects, it is not possible to show tasks in a single view of a Gantt chart, be it on paper or on a computer screen.

- The bars used in a Gantt chart only represents the timeline or timeframe and not the number of hours of work for each task or the resources that are required.

- As it is not easy to see dependencies in a Gantt chart, nor is it possible to determine float times (unlike with critical path analysis), project managers cannot determine the impact of a delay in the completion of an activity on the overall completion of the project.

- For large projects, with many different activities and tasks that require a significant amount of time to complete, it is not possible to display all the information on one computer screen or a single sheet of paper. This can make the information more challenging for project managers to analyse.

- In reality, not everything will necessarily go according to the plan in a Gantt chart. There may be unexpected delays or obstacles that arise, such as severe adverse weather conditions or cases of major staff absences. Therefore, to be of real value, Gantt charts may need to be regularly updated.

- As with all quantitative tools, the value of Gantt charts depends on the accuracy of the underlying data. Project managers need to have accurately identified all the relevant activities in a project as well as their durations. For substantial and multifaceted projects for which the business lacks experience, it is likely that errors and omissions will occur, thereby devaluing the predictions made in the Gantt chart.

Note that Gantt charts and critical path analysis (see Chapter 52) are tools that can both be used for project management. There are some slight differences in these planning tools. A Gantt chart can show precise dates for when a specific task begins and ends (such as from 24th of August to 5th of October). Project managers can take a look at the Gantt chart on any particular day and see exactly what is happening and the overall progress of the project. The bar charts on the Gantt chart diagram can be coloured or shaded in such a way to show progress being made on the particular task.

By contrast, a critical path analysis diagram shows the time frames of the various tasks of a project, such as when an activity can begin and end, but the lengths of the lines have no significance. Hence, it is a little more challenging to see the duration of different tasks and the progress being made. Gantt charts are generally simpler to construct and use as planning tools. This simplicity is appealing and makes Gantt charts popular with project managers. Nevertheless, the consequence of delays and changes to a project are easier to show using critical path analysis.

HIGHER LEVEL

REVIEW QUESTIONS

1. What are Gantt charts?
2. Why do project managers use Gantt charts?
3. What is meant by a 'dependency' in a Gantt chart?
4. What are the main advantages of using Gantt charts as a planning tool?
5. What are the main disadvantages of using Gantt charts as a planning tool?

KEY TERMS

Dependencies in a Gantt chart represent the activities that cannot start until the completion of other preceding tasks.

Gantt charts are a visual representations of all the tasks in a particular project plotted against the timescale, allowing project managers to monitor progress.



Figure 52.4 – Gantt charts can be useful for project managers in charge of large projects

Chapter 53
Business Management Toolkit (BMT) 10 - Porter's generic strategies (HL only)

HIGHER LEVEL

"The essence of strategy is choosing what not to do."
- Michael E. Porter (b.1947), American business strategy academic

Porter's generic strategies (HL only)

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. Porter's generic strategies is a type of decision-making tool.

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Professor Michael E. Porter's **generic strategies** is a business management decision-making tool that outlines the ways that any business can use to gain a competitive advantage. A **competitive advantage** is any positive attribute or trait that sets a business apart from its competitors, which enables it to outperform its rivals.

If a profitable product or idea can be copied easily, then other firms will take advantage by entering the market. Competitors might offer an improved product or charge more competitive prices, for example. Hence, the original firm would lose its competitive advantage. Porter argued that every successful business must have a competitive advantage in order to prevent profits being eroded by rivals entering the market. He suggested that there are three general or broad strategies that any business can use to sustain a competitive advantage (see Figure 53.1).

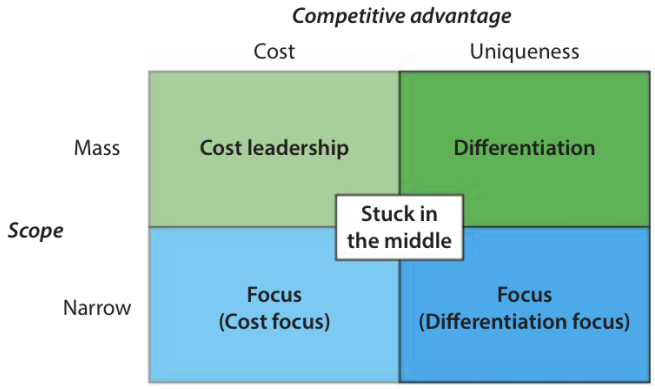

Figure 53.1 - Porter's generic strategies

Cost leadership

Cost leadership is the generic strategy that involves a business becoming the lowest-cost organization in the industry. Firms using a cost leadership strategy strive to become the lowest cost supplier of a product within market. For example, Malaysia's AirAsia is the largest low-cost airline carrier in Asia (also see Box 53.1). Aldi and Lidl are Germany's largest chains of discount supermarkets that operate on an international scale. IKEA, McDonald's, Netflix and Walmart also use this generic strategy.

Note that although these firms are cost leaders, this does not necessarily mean they charge the lowest prices in the market (which is a different strategy known as price leadership). However, cost leadership typically entails firms charging

HIGHER LEVEL

low prices, but also allows them to be highly profitable and market leaders in their respective industries. Cost leaders do not compete with firms that offer higher-quality products since this would require costs to increase. Alternatively, firms might choose to use technology to cut wastage and to improve productivity, thereby further reducing average costs.

There are two cost leadership strategies in Porter's generic strategies model: cost leadership with parity and cost leadership with proximity.

- *Cost leadership with parity* (or *cost parity*) means charging the same price as competitors for the same or similar good or service but lowering costs, thereby increasing its profit margin.

- *Cost leadership with proximity* (or *cost proximity*) means charging a lower price than the average competitor whilst reducing costs which gives the business a price advantage but often with a smaller profit margin.

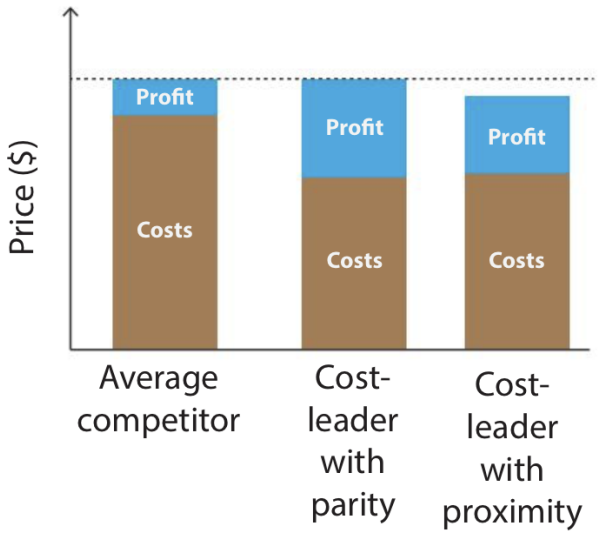

Figure 53.2 - Cost leadership models

Note that with both cost leadership strategies, if the business can reduce its costs even further, it may be possible to reduce price yet still earn the same or higher profit margins.

However, cost leadership (with parity or with proximity) can be a risky strategy if more than one organization tries to achieve competitive advantages in the same market by using the same strategy. This will lead to a price war, which is usually disastrous for businesses in the industry.

Box 53.1 - Features of low-cost (budget) airlines



- Low airfares (cheap ticket prices)
- Use less congested (cheaper) airports in order to reduce costs
- Charge extra for food and drink - no hot meals (which cuts costs even further), just snacks and drinks
- Extra charges for priority booking, seat allocation and baggage
- Limited services (flight destinations)
- Single class travel (no business class or first class seats)
- Single type of aircraft used (reduces training costs and servicing costs)
- No in-flight entertainment – or limited service provided at an extra charge
- No seat recliners and no seat pockets (for magazines and other items).

Exam tip !

Cost leadership is concerned with minimising costs of production – this does not necessarily mean that prices will be lower as the business can enjoy greater profit margins. Remember that 'cost' (incurred by a business) and 'price' (paid by customers) are separate concepts.

Differentiation

Differentiation happens when a firm makes its goods and services distinct from those of its competitors in a way that appeals to its customers (see Box 53.2). Unlike cost leadership, differentiation focuses on the quality rather than the cost of a product. It is about establishing a unique or distinctive selling point for the business or its products. Apple, BMW, Chanel, Lego, Nespresso, Nike, Rolex and Rolls-Royce all use this strategy to maintain their competitive advantage.

A successful differentiation strategy will allow a business to charge a premium price (see Chapter 28), which over and above the cost incurred by differentiation and higher than the industry average. This enables the business to earn a higher profit margin.

Box 53.2 - Examples of differentiation

- Branding
- Colour
- Customer service
- Delivery options
- Design
- Exclusivity
- Features and functions
- Packaging
- Quality (reliability, durability and performance)
- Size
- Technologies and innovations

Advantages of a differentiation strategy include:

- A differentiation strategy allows businesses to make their products more attractive to customers as these are distinct from what competitors offer.
- Product differentiation enables a business to charge premium prices, enabling it to earn higher profit margins.
- It encourages businesses to be more attentive and responsive to the needs and desires of their customers.
- A successful differentiation strategy encourages customer loyalty and brand loyalty.
- It can reduce the degree of rivalry within the industry, thereby benefiting market leaders in particular.
- It can also reduce the price elasticity of demand for products (see Chapter 28) so that customers are less responsive or less sensitive to changes in price.

Disadvantages of a differentiation strategy include:

- Product differentiation is usually expensive, so will increase costs of production, such as the amount of money needed for research and development (see Chapter 42) and to successfully promote and launch a product (see Chapter 29). Although a premium price might be charged, the business needs to ensure that the additional costs do not exceed the price differential due to the differentiation strategy.
- A differentiation strategy requires businesses to continually be innovative and creative in order to add value for customers. This is both time consuming and draining of the firm's scarce resources.
- The strategy also requires substantial and sustained marketing investment in order to attract a sufficient number of customers.

Nevertheless, building a successful differentiation strategy can give businesses, such as Amazon, Heinz and Omega, long-term competitive advantages. They might choose to safeguard their competitive advantage by using intellectual property protection, such as copyrights, patents and trademarks (see Chapter 42).

Focus strategy

The third of Michael Porter's generic strategies is called **focus**, which involves businesses concentrating on a narrow or niche market. A focus strategy occurs when a business targets a niche or single segment of the market. For example, IBID Press focuses on providing specialized and high-quality textbooks for IB Diploma students. There are two alternatives to a focus strategy:

HIGHER LEVEL

- **Cost focus** - Businesses can gain a competitive advantage by focusing on being a low-cost producer in narrow (niche) markets. Examples include Claire's, an American retailer of accessories and low-cost jewellery primarily aimed at tweens and teen girls and Smart cars, which produces microcars and subcompact cars. This strategy involves businesses developing uniquely low-cost products for the market.

- **Differentiation focus** - Businesses can also gain a competitive advantage by focusing on a particular market segment. Examples include Rolls Royce, Rolex, Gucci and Chanel. This strategy involves businesses developing well-specified and high-end products for the market.

Focus can be a highly profitable strategy due to the high prices that can be charged and the lack of competition in the market. Businesses that adopt a focused strategy tend to build strong brand loyalty amongst their customers. The main drawback is that the market size is rather limited.

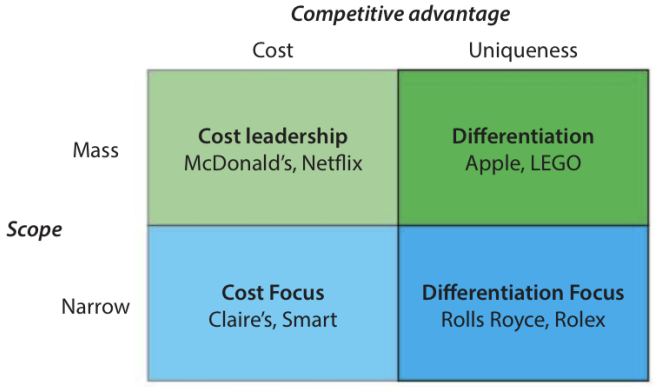

Figure 53.3 - Examples of generic strategies

In summary, a cost focus strategy means a business concentrates on cost-minimization within a narrow or niche market. A differentiation focus strategy means a business concentrates on strategic differentiation within a narrow or niche market.

Stuck in the Middle

Porter's generic strategies help managers to concentrate on a specific strategy that best serves their organizations. The framework suggests that it is not possible in the long-term to adopt a mixture of these generic strategies. For example, it is not feasible to maintain high quality by using a cost leadership strategy, i.e. firms cannot expect to be highly profitable *and* to have a corporate reputation of outstanding quality by charging low prices.

Porter suggests that firms without a clear business strategy are **stuck in the middle**, with detrimental consequences. Such businesses do not have any sustainable competitive advantages, regardless of the industry in which they operate. Instead, the cost leaders, the differentiators and the focusers will all be better positioned to compete against those stuck in the middle. As Margaret Thatcher (the UK's first female Prime Minister) said, "*Standing in the middle of the road is very dangerous; you get knocked down by the traffic from both sides.*" Essentially, Porter argues that each generic strategy is fundamentally different so requires a different approach to gain a competitive advantage.

ATL Activity 53.1 (Thinking and Communication skills)

In small groups of 3 or 4 people, discuss the extent to which Porter's generic strategies apply to the competitive forces facing non-profit organizations such as Oxfam and Greenpeace?

Key concept

Discuss the role of **creativity** in formulating business strategies in order to gain competitive advantages.

Evaluation of Porter's generic strategies

Porter's generic strategies provides a clear and succinct framework for businesses to formulate their growth strategies (see Chapter 5). The growth and evolution of businesses can be pursued by the implementation of any one of Porter's generic strategies, such as economies of scale which are required to pursue a cost leadership strategy

The advantages of using Porter's generic strategies as a business decision making tool includes:

- Porter's generic strategies provides a business with a straightforward framework to decide which of the strategic options to pursue (that is, cost leadership or differentiation) and whether to target the mass market or a narrow (niche) market.
- As a strategic framework, it provides choice and flexibility for entrepreneurs and decision makers in an organization. For example, the right business strategy will change over time as internal and external environments change (see Chapter 44 about SWOT analysis).

However, as with all business management tools, Porter's generic strategies as a decision-making framework has its limitations. These include:

- Porter's strategic framework provides theoretical strategic choices but in reality, the pursuit of these strategies is not always practical. For example, a business cannot simply become the lowest cost provider in the market as this requires significant market power and a large customer base in order to achieve the necessary economies of scale. Similarly, a business might not be able to pursue a differentiation strategy due to the risks and financial costs that this would involve.
- It suggests that businesses should only pursue a single strategy in order to prevent being 'stuck in the middle'. It is possible and not uncommon for large businesses to focus on differentiating themselves by producing good quality products while paying attention to cost efficiency.
- The pursuit of a generic strategy does not guarantee corporate success. For example, cost leadership does not always lead to high profit margins, especially in highly competitive markets where low prices become the norm. Differentiation does not always lead to higher market share. For instance, whilst Apple's iPhones are highly innovative (given the company a unique selling point), Samsung is the market leader with its significantly larger product range of smartphones.
- The generic strategies are not necessarily sustainable business strategies. For example, competitors can imitate any of these generic strategies and/or changes in technologies and innovations can eliminate any competitive advantage that the business currently holds.

Overall, as a popular decision-making tool in the corporate world, Porter's generic strategies help managers and entrepreneurs to concentrate on a specific strategy to gain competitive advantages. He argued that every successful business must have a clear and distinctive competitive advantage in order to remain relevant in the marketplace. For example, businesses can gain a competitive advantage by either focusing on being a low-cost producer (cost focus) such as discount bric-a-brac stores or by differentiation within a particular segment (differentiation focus) such as Ferrari and Gucci. Porter's generic strategies has stood the test of time and is still widely applicable to almost any business in literally every industry.

Theory of Knowledge (TOK)

How can managers know which is the most appropriate business strategy to meet the potentially conflicting interests of the organization's numerous stakeholder groups?

Key concept

Discuss which of Porter's generic strategies is the most **sustainable** strategy in creating competitive advantages for a business of your choice.

HIGHER LEVEL

Question 53.1 - Which generic strategy?

(a) Define the term *generic strategies.* *[2 marks]*

(b) Explain which of Porter's generic strategies are used by the following businesses.

(i) Harrods - a distinct luxury department store in Central London catering for the rich and famous. *[4 marks]*

(ii) KFC - a market leader in the fast-food industry with a globally recognised brand name. *[4 marks]*

(c) Discuss the extent to which Porter's generic strategies apply to global multinational companies. *[10 marks]*



REVIEW QUESTIONS

1. What is Porter's generic strategies?
2. What is a cost leadership strategy?
3. How does cost leadership with parity differ from cost leadership with proximity?
4. What is a differentiation strategy?
5. What are the two types of focus strategy?
6. What does it mean to be 'stuck in the middle'?

KEY TERMS

A **competitive advantage** is any positive attribute or trait that sets a business apart from its competitors, which enables it to outperform its rivals.

Cost focus is a focus strategy used by businesses to gain a competitive advantage by concentrating on being a low-cost producer in narrow (niche) markets.

Cost leadership is the generic strategy that involves a business becoming the lowest-cost organization in the industry.

Cost leadership with parity (or **cost parity**) means charging the same price as competitors for the same or similar good or service but lowering costs.

Cost leadership with proximity (or **cost proximity**) means charging a lower price than the average competitor whilst reducing costs to give the business a price advantage.

Differentiation happens when a firm makes its goods and services distinct from those of its competitors in a way that appeals to its customers.

Differentiation focus is a focus strategy used by businesses to gain a competitive advantage by focusing on a particular market segment developing well-specified and high-end products.

Focus strategies involve targeting a relatively narrow (niche) market. These strategies fall under two categories: *cost focus* and *differentiation focus*.

Porter's generic strategies is a business management decision making tool that outlines the competitive business strategies that any organization can use to compete.

Stuck in the middle is the term used by Porter to describe firms without a clear business strategy, so have no competitive advantages.

Chapter 54
Business Management Toolkit (BMT) 11 - Hofstede's cultural dimensions (HL only)

HIGHER LEVEL

"A people without the knowledge of their past history, origin and culture is like a tree without roots."
- Marcus M. Garvey, (1887-1940), Jamaican entrepreneur and political leader

Hofstede's cultural dimensions (HL only)

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. Hofstede's model of cultural dimensions is a type of situational tool.

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Geert Hendrik Hofstede (1928 – 2020) was a Dutch social psychologist and expert in corporate culture. Professor Hofstede studied the links between international cultures and organizational cultures. According to Hofstede culture can be as *"the collective mental programming of the human mind which distinguishes one group of people from another"*. This is largely shaped by domestic cultural norms and shapes human behaviour in society. Cultural norms are the shared expectations, values and rules that guide behaviour of people within a social group. These norms are passed down from one generation to the next.

This does not mean that everyone in a particular society behaves in the same way as there are significant differences between individual human beings. However, it does suggest that there may be considerable differences among individuals in one country that are noticeably different when compared with cultures in different countries. Such differences in outlook can cause culture clashes within an organization (see Chapter 11).

Hofstede's research gives insight into how organizational cultures may differ from one country to another. National culture has a direct impact on organizational culture. For example, Universal Studios Singapore opened its theme park in 2010 on 18th March at precisely 8:28 a.m. with 18 Chinese lions blazing through the entrance. The number 8 is auspicious in Chinese culture. It is important for organizations with operations in overseas markets to consider the cultural differences that exist. What works well in one culture or country does not necessarily apply to others (also see Chapter 34).



Figure 54.1 - Universal Studios, Singapore

HIGHER LEVEL

Hofstede's cultural dimensions was based on his research of employees working at IBM International (where he worked as a management trainer and manager of personnel research). He interviewed IBM employees in over 70 national subsidiaries to see how cultures may differ around the world within the same organization. The research included Hofstede taking a two-year sabbatical from IBM in 1971 and having conducted around 117,000 surveys, he discovered that there were significant differences between cultures within the same organization in different parts of the world.

Hofstede's original work found five dimensions (types) of culture. These cultural dimensions describe broad patterns of differences between cultures:

1. Power distance

Power distance measures the extent to which there is a clear cultural sense of rank and status in society, i.e. whether subordinates (or citizens) expect and accept unequal distribution of power within an organization (or country). Whilst some people or societies are expected and allowed to challenge the views of their superiors, in others they are simply expected to 'do as they are told'. In such a society, people are not encouraged to ever challenge the ideas put forward by their managers. Large power distance countries include Malaysia, the Philippines and Slovakia. By contrast, a low power distance rating or index, as found in New Zealand and Scandinavian countries, reflects the society's view that people should have equal rights.

Hofstede found that a high power distance culture tends to have centralised decision-making and exists in organizations with tall hierarchical structures (see Chapter 8). This can create a sense of alienation between senior management and employees. workers may feel isolated, disconnected and unappreciated especially if they have minimal, if any, influence in the decision-making process. By contrast, a low power distance culture tends to be decentralized, with delegation and empowerment (see Chapter 10).

Differences in the power distance dimension of culture mean that people will think and behave in different ways. Understanding such differences and working to close the power distance gap can help to prevent culture clashes (see Chapter 11) and make it less difficult for people from dissimilar regions or cultures to work together effectively.

2. Individualism versus Collectivism

This cultural dimension in Hofstede's model measures the extent to which people feel they should care for themselves (individualism) versus caring for or being cared for by the family network and others in society (collectivism). It considers the extent to which people feel it is their responsibility to look after others or whether they feel that this is the responsibility of the government. The USA, UK and Australia are often cited as individualist societies whereas collectivism is important in Chinese, Columbian, Venezuelan and Pakistani cultures.

In a corporate setting, individualistic cultures put emphasis on the needs of the individual over the needs of the group as a whole. By contrast, a collectivist culture stresses the importance of cooperation and interests of the group over the needs of any particular individual.



Figure 54.2 - Collectivism is part of Chinese culture

3. Masculinity versus Femininity

This cultural dimension focuses on the extent to which a culture conforms to traditional gender values and traits. Masculinity refers to the values and behaviours usually dominated by males, such as assertiveness, competitiveness, ambition, status, selfishness and material rewards. According to Hofstede Insights (www.hofstede-insights.com), this culture is found in Japan, Hungary and Slovakia for example. By contrast, femininity refers to the values and attributes traditionally associated with females, such as placing focus on relationships, cooperation, communication and the general quality of life. This culture is found in Thailand, Sweden, Norway and Latvia for example.

In the corporate world, a masculinity culture suggests preference for achievement and material rewards as measures of success. Such organizations do not emphasise harmony and consensus. This differs from a femininity culture, such as observed in charities and other non-profit social enterprises (see Chapter 2), which prefers cooperation, modesty, caring for the less able and improving overall quality of life. Such organizations are more consultative and consensus oriented.

Note that categorizing cultures as 'masculine' or 'feminine' was used by Hofstede over 50 years ago, so the terms are less politically correct in today's world – a clear example of how cultural and social norms change over time!

4. Uncertainty avoidance

This aspect of Hofstede's cultural dimensions measures the extent to which people in an organization or country prefer structured routines (predictability) over flexible structures. It refers to the extent to which individuals in society or organizations are comfortable with uncertainty. Hofstede found that countries with high uncertainty avoidance scores have strong customs and habits. Examples include cultures found in Greece, Portugal and Uruguay. Such societies tend to favour formal structures, rules and regulations (see Chapter 8). In some organizations, people are used to receiving precise instructions, with detailed to-do lists and plans. There are clear guidelines and policies so that people know exactly what they are expected to do and when. People who have a low tolerance of uncertainty avoidance tend to remain loyal to their employers.

By contrast, a society or organization that has a high tolerance for uncertainty avoidance means that there is generally acceptance for new ideas and the ideas of others. Members do not feel uncomfortable with doubt (uncertainty) and are receptive of an unstructured future. Some of the most tolerant nations, with a low uncertainty avoidance score, include Sweden, Denmark and Singapore. Such cultures are conducive to change, growth (see Chapter 5) and innovations (see Chapter 42). Hofstede found that organizations that have a high tolerance for uncertainty are suited to operating in fast-paced industries that witness rapid changes.

5. Long-term versus short-term orientation

This dimension of culture looks at the extent to which a particular culture values making sacrifices today for the benefits to be reaped in the future. According to Hofstede Insights, countries and companies with a culture of long-term orientation, such as India, China, Japan, South Korea and Thailand are focused on the future so invest for the future, have perseverance and are patient with the results. People in such cultures do not seek instant gratification but willingly sacrifice current consumption for future benefits.



Figure 54.3 - Long-term orientation does not seek instant gratifications

By contrast, short-term orientation means that cultures and traditions are kept because people are focused on the present or past and consider this to be more important than the future. They view societal change with an element of suspicion and apprehension. Such orientation, as found in Columbia, Trinidad and Tobago and numerous nations of West Africa, involves people fulfilling their social obligations and respect for and preservation of tradition. Hence, such cultures can be resistant to change (see Chapter 7).

In the corporate world of business, these different outlooks with respect to time directly impact on investment decisions (see Chapter 21). Some managers may only look two or three years ahead, expecting the business to reach break-even quickly (see Chapter 39) and earn a high return on investment in that time. However, other managers are willing to take longer term decisions and risks. They are willing to persevere and work harder for a longer time period to achieve success.

HIGHER LEVEL

6. Indulgence versus self-restraint

In 2010, Hofstede's research led him to add a sixth cultural dimension: *indulgence* versus *self-restraint*. An indulgent culture is one that enables people to let go, have freedom of speech, enjoy life and have fun as a way of life, whereas a culture that emphasises self-restraint has strict social norms to ensure self-regulation and control.

Examples of indulgent countries, according to Hofstede Insight, include Australia, Canada, the US, Argentina, Mexico, El Salvador and Chile. Countries with a moderate level of indulgence include Finland, Sweden, Turkey and Algeria. Pakistan, India, China, Japan, Latvia and Estonia have a culture of self-restraint. People from countries with low scores for indulgence (or high ratings for self-restraint) may be reluctant to offer their personal opinions and may feel guilty or a sense of shame for engaging in trivial activities. They may also consider those who openly indulge as being unprofessional.

As with all dimensions of culture, having an understanding of cultural differences and local business etiquette improves the chances of commercial success. It is therefore vital for managers to be open-minded, mindful and flexible in international social and business encounters.

Case study 54.3 - Culture and etiquette in China



Fresh fruits are often given as gifts in Chinese culture

- The eldest person is always greeted first.
- Business cards should be exchanged with both hands but placing the business card straight into your pocket is regarded as offensive behaviour.
- Fruits and food items are generally appropriate gifts.
- Gifts must be received with both hands – and should not be opened in front of the benefactor.
- It is not acceptable to use red ink for written communications.
- Clocks should never be given as a gift!
- Male colleagues should refrain from wearing green hats if they want any respect!

ATL Activity (Research skills)

Visit the Hofstede Insights webpage (www.hofstede-insights.com/product/compare-countries/) to compare and contrast the different cultural dimensions of different countries across the world. Simply select a country in the dropdown menu to see the values for the cultural dimensions. you can also choose additional countries to see a comparison of their relative scores.

Theory of Knowledge (TOK)

How might different national cultures, traditions and beliefs affect knowledge claims made in Business Management?

Theory of Knowledge (TOK)

How do we know if there is a dominant culture within a nation? How does this influence decision-making for business organizations?

Evaluation of Hofstede's cultural dimensions

Hofstede's cultural dimensions gives managers and decision makers a coherent tool for classifying and discussing cultures within and across organizations. The tool helps to explain a range of social behaviours, based on empirical evidence. A major strength of this tool is that it can help to prevent or minimize culture clashes due to ignorance or misunderstandings, especially in large and multinational companies (see Chapter 6). This helps managers to plan and adapt corporate strategy more appropriately.

However, there are several limitations of Hofstede's cultural dimensions. First, the notion of cultural dimensions is that it may lead to confirmation bias. For example, if researchers believe that American or British culture is individualistic, they may look out for traits in an individual from a research group simply because that is what they expect to see. Also, Hofstede's research was based on a relatively large sample taken from employees at IBM in different countries, but the findings only represented those working at the high-tech company in an office environment. The sample and findings are therefore biased and may not be representative of a larger population and employees in different occupations. Furthermore, what may seem to be a strength in one country (such as individualism or collectivism) could be interpreted as a weakness by others.

Globalization has caused the corporate world to be more integrated and interdependent. Numerous sub-cultures may therefore exist in organizations. The trend towards hiring a workforce that is culturally diverse means that managers and employees may not make decisions in the same way as described by Hofstede's original research and findings. Whilst his research was comprehensive, it is somewhat outdated. For example, describing cultural dimensions as 'masculine' or 'feminine' may seem sexist or offensive in today's business world.

There are many factors that influence culture, not just national identity that Hofstede's work and research focused on (although he was a social psychologist rather than a corporate business manager). We cannot assume that everyone from a country or organization will have the cultural profile that Hofstede identifies in his model of cultural models. After all, this was a particular study at a particular time and conducted in a particular way.

Nevertheless, the tool provides critical insight to gain a better understanding of other cultures that exist. Such awareness is imperative for doing business with others, whether this is domestically or on an international scale. This knowledge is equally important when engaging with mergers and acquisitions, joint ventures, strategic alliances and takeovers (see Chapter 5) in order to improve the chances of success in amalgamating companies with potentially contrasting corporate cultures.

Question 54.1 - Wahaha and Danone's joint venture

Wahaha, China's largest beverage producer, formed a joint venture with France's largest food company, Danone, in 1996. When Wahaha's founder stepped down in 2007, several disputes broke out between the two companies, including the choice of a new chairperson. Both companies wanted their own representative to take over the company. Danone then claimed that the Chinese had illegally copied some of its drinks. Under the joint venture agreement, Wahaha was not allowed to make products that directly competed with Danone's range of drinks products. Danone also faced pressures from Chinese officials when thousands of bottles of its Evian water were seized on accusations that they contained unsafe microorganisms

(a) Define the term *joint venture*. *[2 marks]*

(b) Explain the importance of understanding cultures for the success of cross-border joint ventures. *[4 marks]*

(c) In the context of the case study, explain **two** limitations of Hofstede's cultural dimensions as a business management tool. *[4 marks]*

HIGHER LEVEL

Theory of Knowledge (TOK)

How can we know the extent to which Hofstede's cultural dimensions might actually reflect a diverse population in a society?

REVIEW QUESTIONS

1. What is Hofstede's cultural dimensions?
2. What is power distance and how does this inform situational analysis?
3. How does individualism differ from collectivism?
4. What did Hofstede mean by masculinity versus femininity in the context of cultural differences?
5. What is uncertainty avoidance?
6. How does long-term orientation differ from short-term orientation?
7. What is an indulgent culture and how does this differ from a culture of self-restraint?
8. What are the main benefits and limitations of using Hofstede's cultural dimensions as a business management situational tool?

KEY TERMS

Collectivism is a dimension of culture that stresses the importance of cooperation and the interests of others over the needs of a particular individual.

Cultural dimensions refer to Geert Hofstede's framework to which members of different cultures can generally be classified. The tool describes broad patterns of differences between aspects of cultures.

Femininity refers to the values and attributes traditionally associated with females, such as placing focus on relationships, cooperation, communication and the general quality of life.

Individualism is a cultural dimension that emphasises the needs of the individual over the needs of others as a whole.

Indulgence relates to the need for people to have fun and freedom as part of their social norm.

Long-term orientation exists in cultures that focus on the future, so people and firms invest for the future, have perseverance and are patient with the results.

Masculinity refers to the values and behaviours usually dominated by males, such as assertiveness, competitiveness, ambition, status, selfishness and material rewards.

Power distance measures the extent to which there is a clear cultural sense of rank and status in society.

Self-restraint is a dimension of culture where people are reluctant to offer their personal opinions and refrain from engaging in trivial activities in order to maintain perceived professionalism.

Short-term orientation exists in cultures where traditions are kept as people are focused on the present or past, viewing societal change with some suspicion and apprehension.

Uncertainty avoidance refers to the extent to which individuals in societies and organizations are comfortable with uncertainty and risks.

Chapter 55
Business Management Toolkit (BMT) 12 - Force field analysis (HL only)

HIGHER LEVEL

"Growth is painful. Change is painful. But nothing is as painful as staying stuck somewhere you don't belong."
- N. R. Narayana Murthy (b.1946), Founder and Chairman emeritus of Infosys

Force field analysis

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. Force field analysis is both a type of situational and decision-making tool.

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Force field analysis was developed by German American social psychologist Kurt Lewin in 1943. It is a situational and decision-making tool that deals with the forces for and against change. Professor Lewin (1890 - 1947) argued that successful businesses tend to be constantly adapting and changing, rather than being fixed in outdated practices and unable to look or move forward. Force field analysis consists of two types of forces:

- **Driving forces** push for change. These represent the arguments or reasons for change.
- **Restraining forces** act against change. These are the factors (or forces) that resist change.

The relative strength of these forces determines whether the change should take place (be implemented in the workplace).

There are several steps involved in a force field analysis (FFA):

1. Identify the goal (purpose of the proposed change).
2. List the driving forces in favour of change and the restraining forces against change.
3. Allocate a statistical weight to each of these forces, from 1 (weak) to 5 (strong) based on the level of importance to the organization and then total the scores for the driving forces and restraining forces.
4. Construct the FFA diagram for a visual representation of the results (see Figure 55.1).
5. Analyse the results in order to (i) decide whether or not to proceed with the proposed change, (ii) determine how best to weaken the restraining forces and (iii) decide how best to strengthen the driving forces.

For example, a business deciding whether to transfer its production facilities to an overseas location might produce a FFA that looks similar to the one in Figure 55.1:

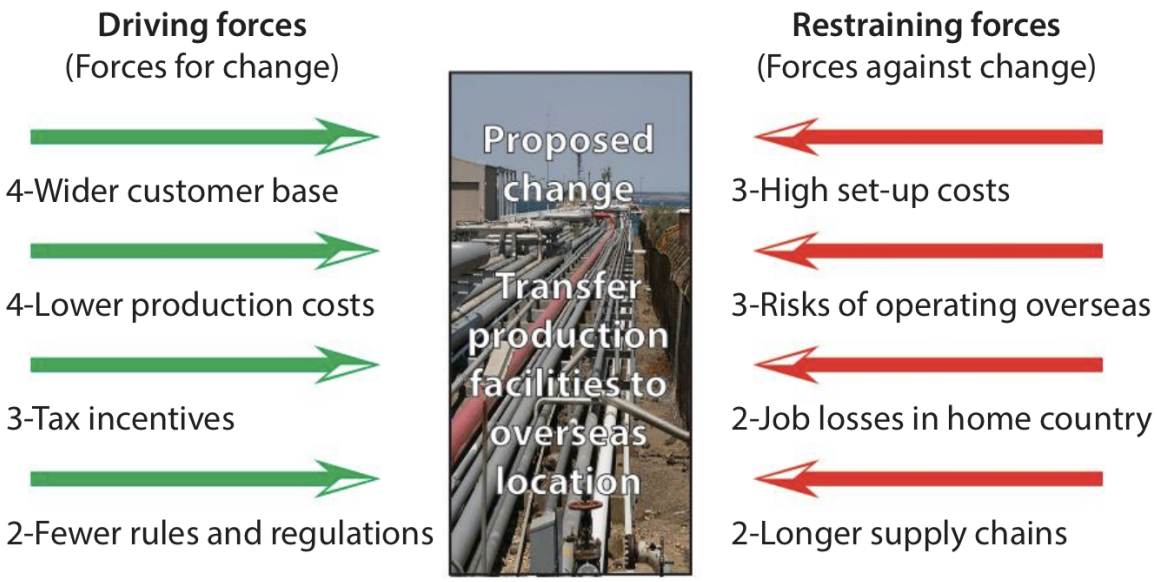

Figure 55.1 - Example of a force field analysis

Figure 55.1 shows that in this case the driving forces for change outweigh the restraining forces against the change. Even if managers have already decided they prefer this option, conducting a FFA can help to make this decision more objective. It also provides a framework for managers to consider *how* best to improve the project's chances of success. This is done by investigating how the driving forces can be strengthened and how the restraining forces can be minimized.

Whilst the problems of change management and resistance to change (see Chapter 7) are not solved by FFA, it still enables managers to examine the driving and restraining forces in a more coherent and focused way. Lewin argued that progress is not the result of one-off changes but by many small changes and improvements.

The advantages of using FFA as a situational and decision-making tool include:

- It offers a visual interpretation of the driving forces for and restraining forces against change. This makes it more straightforward to understand the different factors that need to be considered in order to make better informed choices.
- The statistical weights used in FFA help managers and decision makers to look at business problems and issues in a more logical and methodical way. This can improve business decision making and help organizations to develop more suitable business plans (see Chapter 48) to achieve their organizational objectives (see Chapter 3).
- Unlike SWOT analysis (see Chapter 44) or STEEPLE analysis (see Chapter 46), the use of FFA analysis requires managers and decision makers to assess the relative strengths of the driving and restraining forces by applying a statistical weight to each of these factors.

There are two main weaknesses of using FFA as a situational and decision-making tool:

- The weights attached to the driving and restraining forces might be done subjectively rather than based on facts or evidence, perhaps to over-emphasise the need for change.
- Not all relevant forces might be considered. There is always a possibility that some factors, be they driving and/or restraining forces, can arise that were not previously considered as managers did not think these actually existed at the time.

Exam tip !

It is important to note that the quantity of driving forces and restraining forces in a FFA is not as important as the relative strength (weights) of each force. So, whilst there could be many different restraining forces against a certain option, simply one or two very important (heavily weighted) driving forces may be sufficient to convince decision makers to proceed with the proposed change.

HIGHER LEVEL

Question 55.1 - Tyagi Enterprise

The management team at Tyagi Enterprise (TE) is deciding whether to the company should invest in new capital equipment in order to increase its output. The team has identified the following driving and restraining forces as well as attaching their weights to each of these factors. These weights are the numbers shown in brackets (where 1 = weak and 5 = strong).

- Training needed to upskill workers to use the new capital equipment (2).
- There has been a steady and sustained increase in the number of customers (4).
- Upgrading the capital equipment will help TE to stay competitive (3).
- Some staff redundancies will occur, so need to be handled carefully (3).
- The maintenance costs of the current capital equipment have been increasing (2).
- The cost of the new capital equipment is expensive (3).

(a) Construct a force field analysis diagram of the driving and restraining forces for TE. *[4 marks]*

(b) Comment on the results of your force field analysis for TE. *[2 marks]*

Evaluation of force field analysis

Overall, the effectiveness of force field analysis will depend on the quality of the data (in terms of suitability, breadth and depth) and how well or accurate the data is interpreted in order to select the right choice. Despite the tool relying on scientific decision-making processes, the role of intuitive thinking and management (see Chapter 9) can skew the results of a force field analysis. Hence, the outcomes of a FFA can have a direct impact on whether implementation of an organization's strategic plan is effective in influencing change.

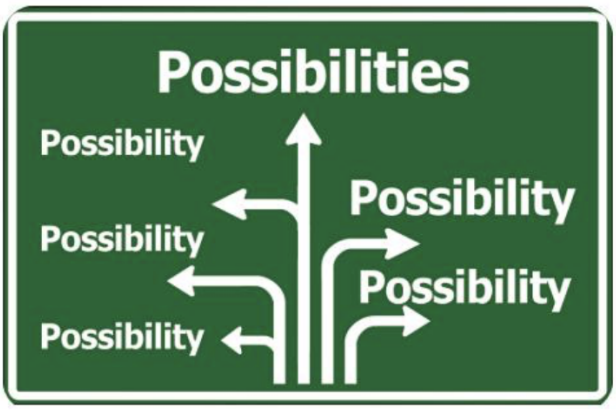

Figure 55.2 - FFA can help managers to make more informed decisions

Nevertheless, Lewin's force field analysis is a useful situational tool as it allows managers to decide what might need changing as well as looking at the forces acting for and against change. It is also a useful decision-making tool as it informs managers whether the restraining or driving forces are stronger. This forms the basis for effective change management (see Chapter 7).

If change is desired, managers can analyse and devise appropriate plans to influence the forces to make the change happen. FFA is essentially a specialised technique of weighing up advantages and disadvantages to help decide whether a proposed change is worth implementing. Hence, FFA can be used as a strategy for reducing the impact of change and resistance to change (see Chapter 7). However, as the tool is static (representing the position at one point in time, it is important for managers to continually review the situation and progress because the driving and/or restraining forces can change at any time due to changes in the internal and external environments (see Chapter 46).

HIGHER LEVEL

Finally, it is important to note that for this tool to be of any real value, force field analysis requires managers and decision makers to apply the weights to each restraining and driving force in an objective and honest manner. If the weights are assigned arbitrarily, the results will add very little, if any, value to the decision-making process.

Key concept

What is the role of intuition in **ethical** decision-making?

Key concept

How significant is **creativity** in strategic decision-making?



Figure 55.3 - Force field analysis can help firms to decide whether it is the right time for change

REVIEW QUESTIONS

1. What is force field analysis (FFA)?
2. How do driving forces and restraining forces differ?
3. What are the benefits to an organization of using FFA?
4. What are the limitations of FFA?
5. How are the weights in a force field analysis assigned?

KEY TERMS

Business Management Toolkit (BMT)

Driving forces in a force field analysis show the reasons for (benefits of) change, such as such as reduced costs and improved productivity.

Force field analysis is an organizational planning tool that deals with the forces for and against change.

Restraining forces in a force field analysis show the reasons against (drawbacks of) change and hence the causes of resistance to change.

Chapter 56
Business Management Toolkit (BMT) 13 - Critical path analysis (HL only)

HIGHER LEVEL

"The people may be made to follow a path of action, but they may not be made to understand it."
- Confucius (551 BC - 479 BC), Chinese Philosopher

Critical path analysis (HL only)

The Business Management toolkit iis a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. Critical path analysis is a type of planning tool.

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Critical path analysis (CPA) is a management planning tool which serves to improve the efficiency of the production processes in a project. It does this by systematically scheduling all tasks and resources required to complete a project in the minimum amount of time. Critical path analysis (or the **critical path method** as it is often called) is an essential tool used in project management. CPA was developed by fellow Americans James E. Kelley and Morgan R. Walker in 1956.

Project management is the planning and coordination of different jobs and tasks in a particular project. It is especially important for firms dealing with large projects and developments, such as the construction of motorways, bridges and residential property. Such projects can involve the planning and coordination of hundreds or even thousands of different jobs and tasks. Some activities will take longer than others, whilst some jobs must be completed before another task begins and yet other activities can take place at the same time. CPA stresses the importance of placing the various activities of a project into a coherent sequence. This is particularly important for complicated and large projects that need to be managed and controlled carefully.



Figure 56.1 - Critical path analysis is a crucial part of project management

Unit 5.6 Production planning (see Chapter 40) explained that idle resources and stockpiling are costly to a business. There is little point in buying stocks (inventories) and hiring labour in advance when they are not to be used for several days, weeks or even months. Critical path analysis (sometimes referred to as **network analysis**) involves setting deadlines for all tasks to ensure the smooth operation and progress of the project. From the network analysis (presented as a diagrammatic interpretation of the various sequences and tasks in the project) project managers can attempt to minimise production costs by allocating resources to complete the project in the shortest available time.

Production delays can be very costly to a business. For example, Airbus initially claimed it would reach break-even on its 'super jumbo' Airbus A380 on the sale of 250 units. However, due to major production problems and delays, Airbus announced

HIGHER LEVEL

within a year of the initial statement that the revised break-even figure had increased by 68% to 420 units (partly due to financial compensations to airlines such as Singapore Airlines and Emirates for late deliveries).

Critical path analysis diagrams

Completion and analyses of a critical path diagram (drawing of the diagram is not expected).

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The ultimate purpose of critical path analysis is to identify the minimum amount of time needed to complete a project. It requires the various tasks of a project to be planned in a logical and coherent way so that the different processes are completed with minimal delay and maximum efficiency.

The process of network analysis (or critical path analysis) involves the following steps:

- Identifying all the operations required for the completion of a project.
- Breaking down the project into separate tasks.
- Determining how long each task is expected to take.
- Identifying all **dependencies** in the project (activities that cannot start until the completion of other prior jobs).
- Determining which tasks can take place concurrently (to minimize production time).
- Placing all operations in the right sequence on a network diagram.
- Showing the *earliest start time* (EST) and the *latest finishing time* (LFT) of each activity in the project.
- Identifying the **critical path** from the network diagram (the minimum time needed to complete the whole project).

Activities that cannot be delayed are known as **critical activities**. Any hold-ups to these operations on the critical path will delay completion of the project.

Constructing networks diagrams

There are several key features shown in a network analysis diagram:

- **Nodes** show the start and finish times of each activity within the project (see Figure 56.2). Each node is numbered to identify the sequence of activities.
- Arrows are used to show the sequence and duration of each activity or task in the project.
- The **earliest start time** (EST) of each activity is shown in the top right-hand part of the node (see Figure 56.2). This shows when a particular activity can begin. The EST will depend on the duration of all previous activities.
- The **latest finishing time** (LFT) is the deadline for a particular activity to be completed so that the entire project can finish in minimal time. The LFT of each activity is shown in the bottom right-hand part of the node (see Figure 56.2).
- The **float** shows the difference between the EST and LFT for each activity. It identifies any spare time that might exist for particular tasks.

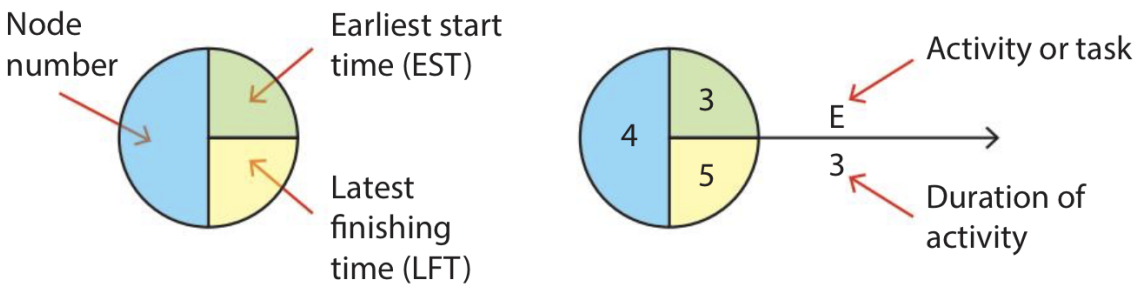


Figure 56.2 - Network nodes

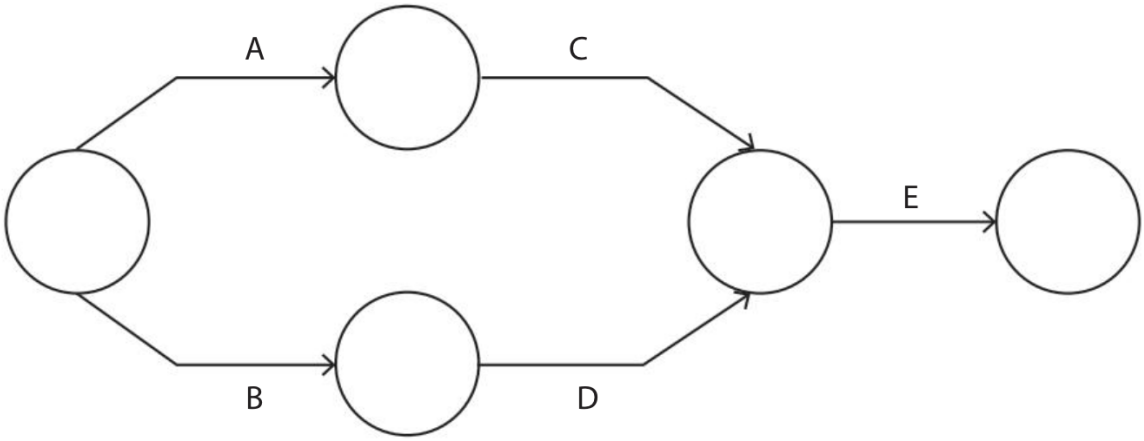


Figure 56.3 - Simplified network

In this particular project, we can see that:

- Activities A and B can be started at the same time
- Activity C cannot start until activity A is completed
- Activity D cannot start until activity B is completed
- When activities C and D are both completed (not necessarily at the same time), then activity E can start.

To construct a network diagram, consider the following simplified example which involves planning an end-of-year office party. Assume that a date has already been set for the end-of-year office party. The following steps are used:

1. Identify the tasks involved in the project
2. Put these in the correct chronological sequence
3. Identify tasks that can take place at the same time
4. Construct the network
5. Identify the critical path.

The first three steps can be shown in the table below. Steps 4 and 5 are shown in the network diagram in Figure 56.4.

Activity	Description	Preceded by	Duration (days)
A	Send out invites and wait for replies	-	7
B	Research and book suitable venue based on number of replies	A	2
C	Book entertainment (music and awards ceremony)	B	5
D	Order food and drinks for delivery	B	7
E	Set up venue, music and stage ready for the party	C, D	3

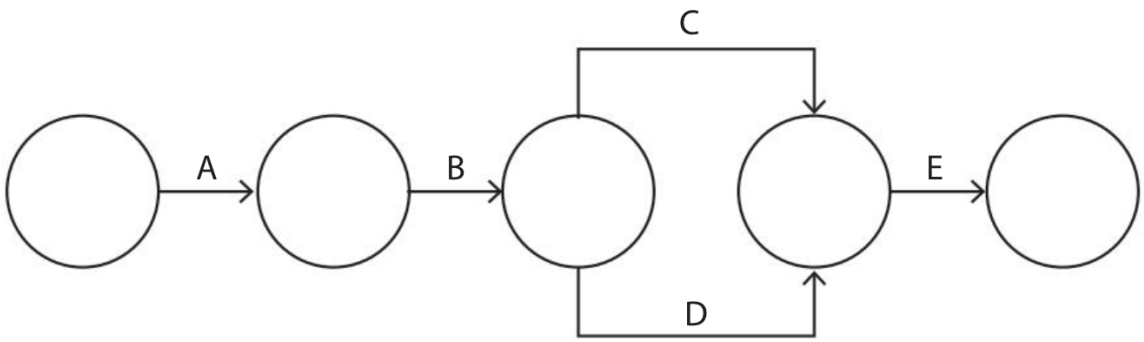


Figure 56.4 - Critical path analysis

Without network analysis, the individual tasks amount to 24 days. However, through working out the critical path, the project is reduced to just 19 days, as shown in Figure 56.4. First, though, it is necessary to construct the network as shown below.

The next step is to put in the missing figures for the earliest start time (EST) for each activity. The top-right space of a node is used to show the EST of an activity, as shown in Figure 56.5.

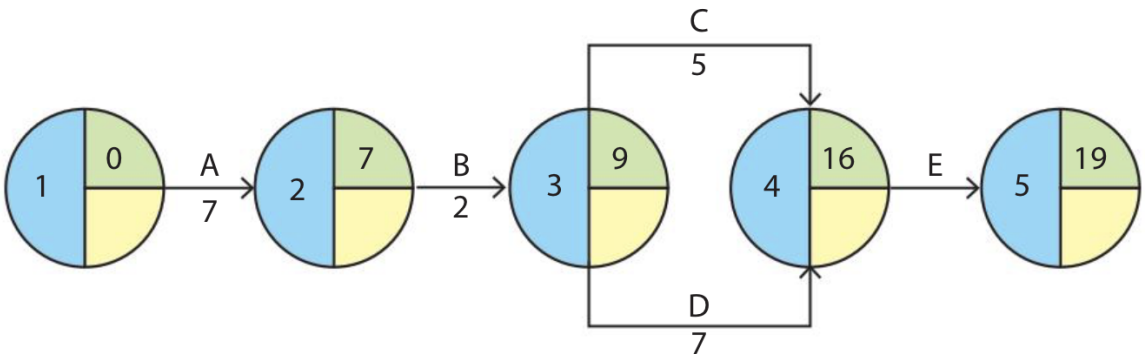


Figure 56.5 - Critical path analysis (with EST)

The following can be seen from Figure 56.5 above:

- Task A takes 7 days to complete. Therefore, the EST for activity B is in 7 days' time (as shown in Node 2).
- Task B takes 2 days to complete. This means that activities C and D cannot start until the 9th day (as shown in Node 3).
- Task C starts on day 9 with a duration of 5 days. Hence, it is completed on the 14th day at the earliest.
- Activity D can take place at the same time as Task C. It takes 7 days to complete activity D.
- Although task C can be finished by the 14th day, task E cannot start until activity D is also completed. Hence, completion of task C can be slightly delayed without there being a delay to the overall project.
- Task E can only start when both tasks C and D are completed. Since task D starts on the 9th day and lasts 7 days, it will be on the 16th day that task E can be started.
- Task E takes a further 3 days, so the shortest time the entire project can be completed is 19 days.

- The next step is to calculate the latest finishing time (LFT) for each activity without extending (or delaying) the whole project. In order to work out the EST, we work from left to right. Conversely, to work out the LFT, we must work back from right to left. In this case, we start at Node 5 as shown in Figure 56.5. As the shortest time needed to complete this project is nineteen days, then the LFT must also be 19 days if there is to be a critical path. The LFT for all previous nodes is calculated by using the formula:

LFT = EST (next node) – Duration

So, for example, the LFT for activity A as shown in Figure 56.6 below is calculated as: 9 – 2 = 7.

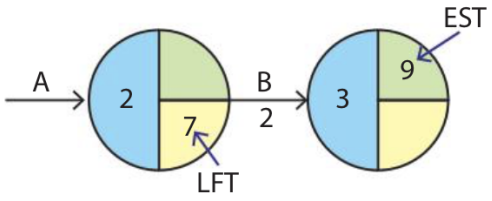


Figure 56.6 - Calculating the LFT

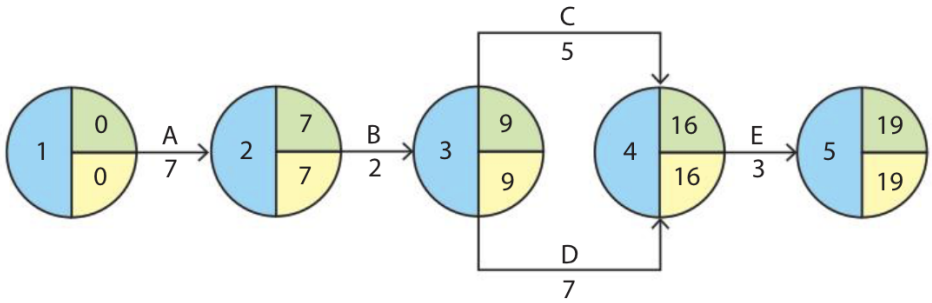


Figure 56.7 - Critical path analysis (with EST and LFT)

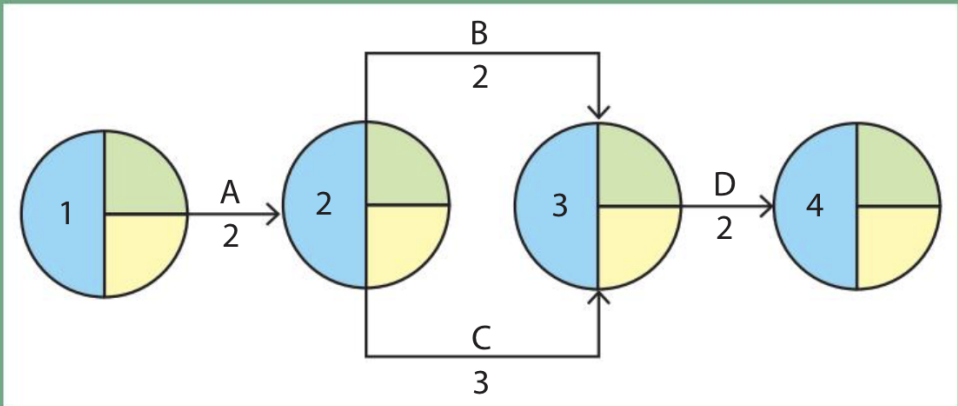
- The LFT is shown in the bottom-right section of a node.
- The LFT for task D is 16 days because the EST at Node 5 is 19 and the duration of task E is 3 days (19 – 3). This figure is then placed in the bottom-right space of Node 4.
- The LFT for task C is also 16 days for the same reason as above.
- For Node 3, the LFT is 9 since Node 4 shows 16 – 7 = 9 days. For task C, the LFT is 16 – 5 = 11 days. When choosing between two different LFT figures (as in the case of Node 3), use the path that gives the lowest LFT to prevent any delays to the project.
- The critical path is shown by the lines in bold in the diagram. Alternatively, it can be shown by marking '//' on all activities on the critical path (see Figure 56.9).
- Task C has a float of 2 days (16 –14 = 2 days or 16 – 5 – 9 = 2 days), i.e., it can be delayed by up to 2 days without affecting the completion date of the project.
- The EST and LFT are exactly the same for all nodes on the critical path. This simply means that the next activity is started as soon as the preceding task is completed to prevent any delays to the project.

HIGHER LEVEL

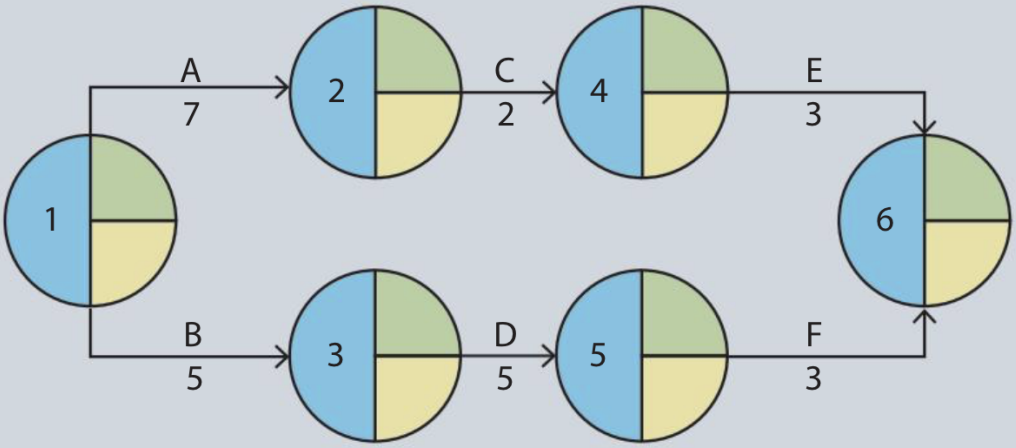
Worked example

Use the data in the table below, complete the network diagram below and identify the critical path. *[4 marks]*

Task	Preceded by	Duration (days)
A	-	2
B	A	2
C	A	3
D	B, C	2



Question 56.1 - Calculating the EST and LFT



(a) Distinguish between the terms *earliest start time* (EST) and *latest finishing time* (LFT). *[3 marks]*

(b) Calculate the missing figures for the EST and LFT in the network diagram above. *[6 marks]*

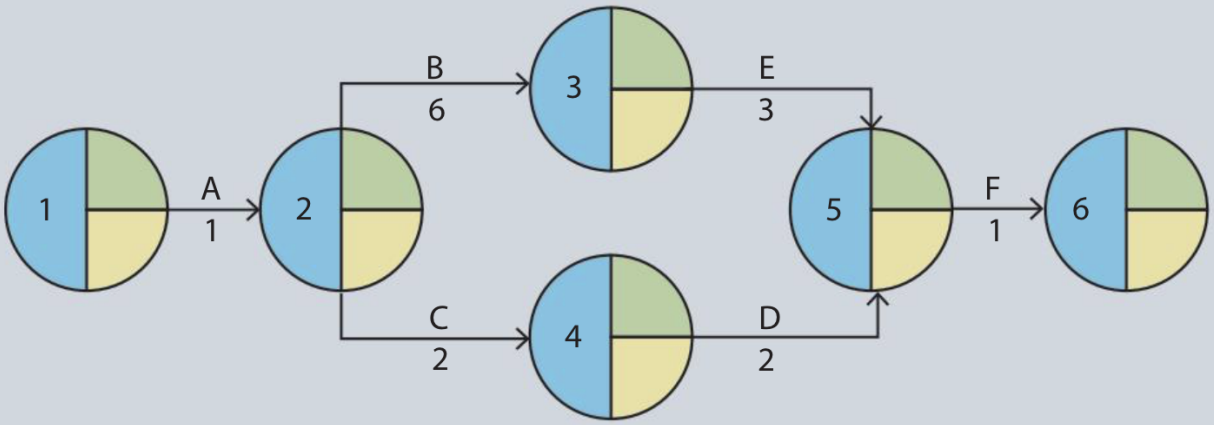
(c) Identify the critical path from the above network. *[1 mark]*

Question 56.2 - Sztomberski Contractors

Sztomberski Contractors specialises in the planning and construction of houses in Nîmes, southern France. The operations director, Marcin Sztomberski, has recently taken on a project to extend an existing four-bedroom home with plans for an outdoor pool. Sztomberski Contractors has already secured planning permission from the local authorities. The project's tasks, duration and sequence are outlined below.



- A - Lay foundation to the house: 1 week.
- B - Construction of house: 6 weeks. B is preceded by A.
- C - Excavation and foundation for swimming pool: 2 weeks. C is preceded by A.
- D - Tiling and sealing of pool: 2 weeks. D is preceded by C.
- E - Internal décor and fixtures for the house: 3 weeks. E is preceded by B.
- F - Final testing and handing over keys to the new owner: 1 week. F is preceded by activities D and E.



(a) Complete the network diagram for Sztomberski Contractors using the above information. Clearly mark the critical path on your diagram. *[6 marks]*

(b) Explain why network analysis can be important for businesses such as Sztomberski Contractors. *[4 marks]*

Exam tip !

When choosing between two different LFT for the same node, use the path that gives the *lowest* LFT to prevent any delays to the project.

Exam tip !

Critical path analysis (CPA) can be very challenging for a lot of students, so the only way to improve is by practising your technique. Even if your calculations are slightly wrong, marks can be awarded for correctly interpreting and explaining the diagram.

HIGHER LEVEL

The free and total float

Calculation of free float and total float.

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The **float** in a critical path analysis identifies any activities that can be delayed without affecting the deadline of the project. Calculating the float allows project managers to consider how best to use any spare time, perhaps by coordinating staff and resources more effectively. First, consider the following sequence of events for Project X.

Task	Preceded by	Estimated time (weeks)
A	-	1
B	-	3
C	B	2
D	C, A	3
E	D	2
F	D	3
G	E, F	2

The order of the above events for this project is shown in Figure 56.8.

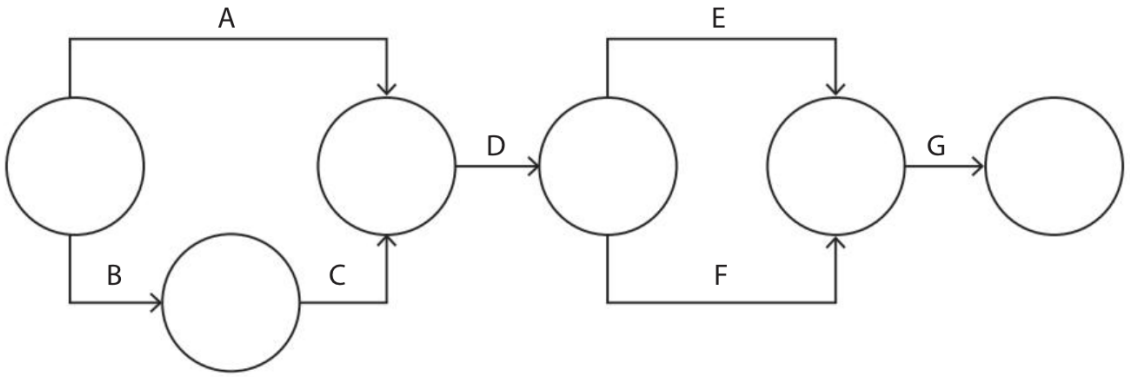


Figure 56.8 - Network diagram for Project X

The next stage is to put in the figures for each node, as shown in Figure 56.9

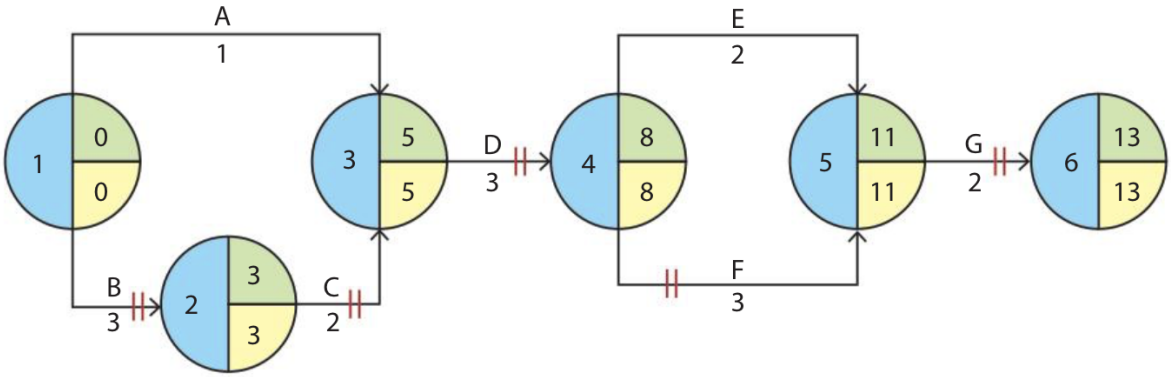


Figure 56.9 - Network analysis for Project X (with EST and LFT)

Hence, the critical path for Project X is B, C, D, F and G. This is shown in the network diagram by 'double striking' the activities on the critical path.

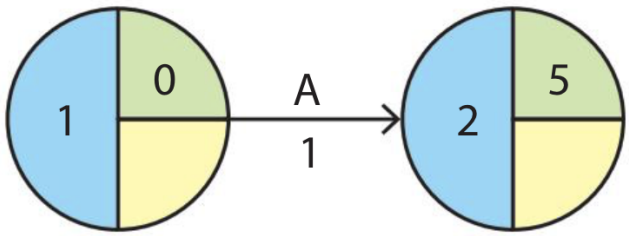
The activities that are not on the critical path (in this case, tasks A and E), have some spare or float time. This means that they can be delayed without affecting the estimated completion time of the overall project. In other words, trying to speed up these activities does not get the project completed any sooner. Calculating the float can be important as managers will become aware of the maximum time that the activity can be delayed; holdups that are longer than the float time will cause a delay to the overall project. There are two main ways to calculate the float: (i) the free float and (ii) the total float.

(i) The free float

The **free float** refers to the amount of time that an activity can be delayed without affecting the EST of the *next* activity in the project. Of course, activities on the critical path do not have any float time. The formula for calculating the free float is:

Free float = EST of next node – Duration – EST of current node

For Project X, only two activities do not lie on the critical path, namely activities A and E. Using the formula, the free float for activity A is 5 – 1 – 0 = 4, as shown in Figure 56.10 below. This means activity A can be delayed by up to 4 weeks without delaying the EST of the next activity (in this case, activity D).



The free float for activity
A = 5 – 1 – 0 = **4 weeks**

Figure 56.10 - Calculating the free float (Activity A)

The free float for activity E is 11 – 2 – 8 = 1 week. This means that activity E can be completed by the 10th week but has a float of 1 week as the following activity (in this case, activity G) cannot start until week 11 when activity F has also been completed.

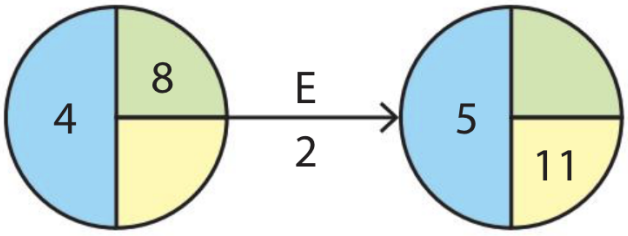
(ii) The total float

The alternative approach to calculating the free float is to use the **total float.** This refers to the amount of spare time available to an activity without causing a delay to the *overall* (total) project.

The calculation of total float for each individual activity is found by the formula:

Total Float = LFT – Duration – EST

So, for activity A (which only takes 1 week to complete) the total float is 5 – 1 – 0 = 4 weeks. This is because activity D cannot start until activity C is completed, on week 5 at the earliest. For activity E, the total float is 11 – 2 – 8 = 1 week, as shown in Figure 56.11.



The total float for activity
E = 11 – 2 – 8 = **1 week**

Figure 56.11 - Calculating the total float (Activity E)

The float times for all activities for Project X are shown in Table 56.1 below.

Table 56.1 - Free float and total float for Project X

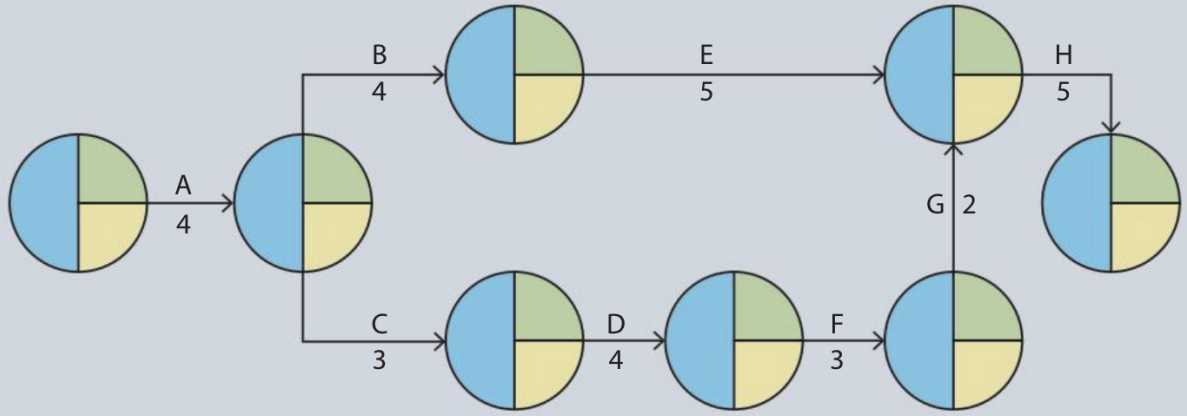
Task	Duration (weeks)	EST	LFT	Free float	Total float
A	1	0	5	4	4
B	3	0	3	0	0*
C	2	3	5	0	0*
D	3	5	8	0	0*
E	2	8	11	1	1
F	3	8	11	0	0*
G	2	11	13	0	0*

* Activities that have no total float lie on the critical path. See Question 56.3 for an example where the free float and total float can differ for the same task.

HIGHER LEVEL

Question 56.3 - David Plumb Decorators Ltd.

David Plumb Decorators Ltd. is a home improvement firm that operates in the suburbs of Melbourne, Australia. The firm has recently taken on a project which involves eight key phases, as shown in the network diagram below.



(a) Complete the network diagram to calculate the minimum time needed (in days) to complete the project. *[5 marks]*

(b) Identify the critical path for David Plumb Decorators Ltd. *[1 mark]*

(c) Define the term *critical path*. *[2 marks]*

(d) Distinguish between total float and free float. *[3 marks]*

(e) Calculate the free float and total float for the above project. *[4 marks]*

Dummy activities

A **dummy activity** (or sometimes referred to as a **dummy variable**) is a logical dependency between two indirectly linked tasks. It is used to prevent an illogical path from being followed in a network diagram and is shown by a dotted arrow line in a network diagram (see Figure 56.13). As an example, consider the following plan of events for Project Y:

Activity	Duration (days)	Preceding activity
A	2	-
B	3	-
C	2	A
D	3	A, B

Without using a dummy activity, the network diagram might look like the one in Figure 56.11, where figures cannot be entered for Node 3, as activity is directly dependent on the completion of activities A and B, but not activity C. This makes the project illogical, thereby defeating the purpose of critical path analysis.

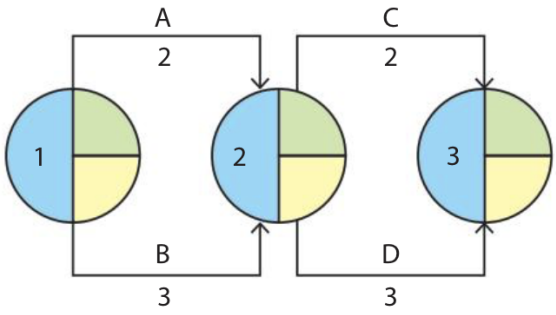


Figure 56.12 - Incorrect network diagram for Project Y

In the above case, it is not possible to complete the EST and LFT for Node 3 as there is conflict between activities C and D, which are not directly related. The network diagram in Figure 56.11 would suggest that activity C is *dependent* on both A and B being completed (the same applies to activity D); but this is clearly not supposed to be the case as shown in the table above. Hence, the project requires the use of a dummy activity, as shown in Figure 56.13. Technically, dummy activities are not activities at all (since they do not consume any time or resources in the project) but act as a visual aid in a network diagram to clarify logical dependencies.

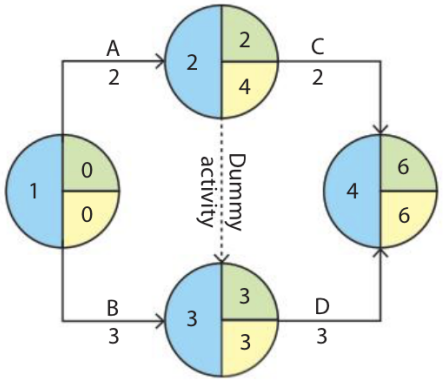


Figure 56.13 - Correct network diagram (with dummy activity) for Project Y

The dummy activity in Figure 56.13 shows that activities C and D are not directly linked, i.e. C follows A only and D happens on the completion of activities A and B. Remember that an arrowed line in a network diagram represents an activity, so there should not be a solid line from Node 2 to Node 3 in this case. Hence, the dummy activity is shown as a broken dotted line connecting these two nodes.

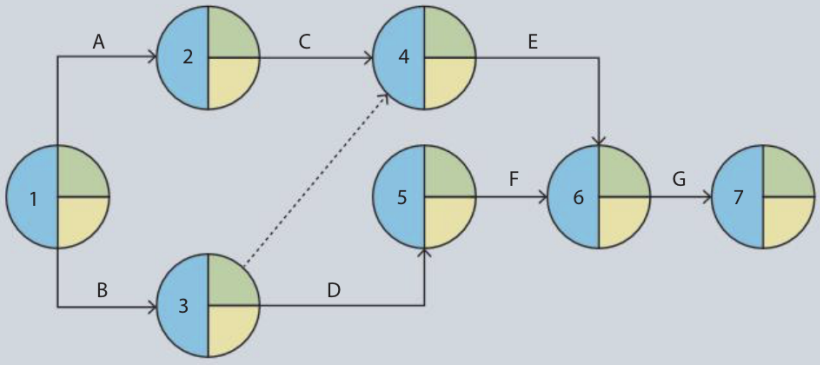
Exam tip !

Dummy activities may be included in a network diagram as they help to identify the critical path (activities B and D in the previous example). However, you are not expected to construct or draw a critical path diagram, so if there is a need for a dummy activity or activities, this will be included in a network diagram for you in the exam.

Question 56.4 - Hobert Lastrollo Engineering Co.

Hobert Lastrollo Engineering Co. has taken on a project with the details shown below.

Task	Order (preceded by)	Estimated time (weeks)
A	-	4
B	-	4
C	A	6
D	B	5
E	B, C	2
F	D	4
G	E, F	3



(a) Define the term *dummy activity*. *[2 marks]*

(b) Use the information above to complete the network diagram for the above project for Hobert Lastrollo Engineering Co. and clearly mark the critical path. *[6 marks]*

HIGHER LEVEL

Evaluation of critical path analysis

As a planning tool, critical path analysis can provide numerous benefits for project management. These advantages include:

- CPA provides a visual representation of a complex project which can therefore make it easier for people to interpret.
- As a planning tool, CPA encourages forward planning and enables project managers to consider different aspects of a particular project, such as the management of different resources at different stages of the project.
- It promotes operational efficiency by identifying the critical path (the shortest time in which a project can be completed). By calculating float times and determining tasks that can be carried out simultaneously, project managers are able to reduce any lost time between different activities, thereby ensuring the project runs smoothly. Operational efficiency also means that the customer will get timely delivery of their order.
- CPA can help a firm with its budgeting (see Chapter 22) and to have better cash flow management (see Chapter 20). By identifying when activities can start and how long tasks should last, project managers can have better cost control. This is particular important for businesses such as construction companies that have long working capital cycles (see Chapters 19 and 20).
- Similarly, CPA can be useful for production planning and stock control (see Chapter 40). Raw materials and components only need to be ordered in time for the EST of each activity and no sooner. This also helps to reduce storage costs.
- CPA can be used for a range of business issues and problems, from small-scale projects to huge undertakings that involve thousands of processes. It works particularly well with just-in-time production systems (see Chapter 37).

However, as with any quantitative tool, CPA also has its limitations. These include:

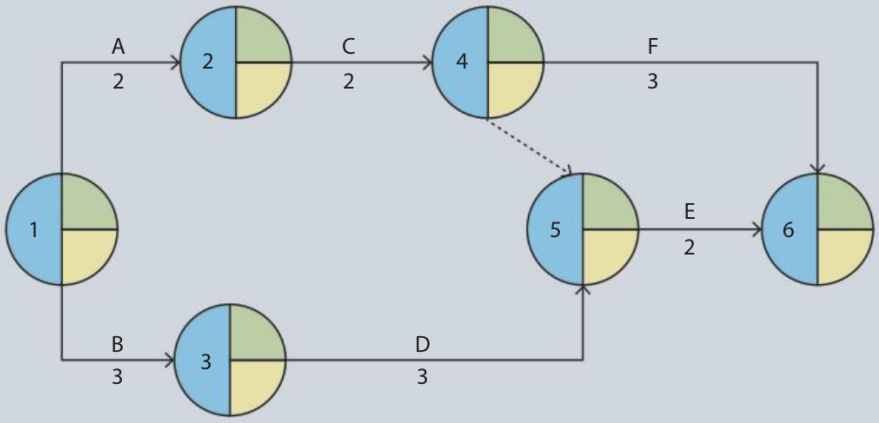
- No matter how impressive or well-planned, network analysis does not guarantee that everything will go according to plan. Internal and external factors (see Chapter 46) can cause disruptions and delays to the completion of a project. For example, poor weather can prolong construction projects.
- As with most quantitative tools, CPA is only useful if the data used to construct the network analysis is accurate and reliable.
- The purpose of CPA is to determine the quickest time to complete a given project. However, this does not guarantee that the project is the best one to pursue. Other methods, such as investment appraisal (see Chapter 21) can help to determine whether the firm's resources could be used more effectively on other projects.
- Similarly, if any necessary steps are not identified in the network analysis (perhaps due to oversight or a change in unforeseen circumstances), then the CPA will be inaccurate.
- Constructing a CPA for huge-scale projects can be very complex, highly challenging and time consuming. This might make the process unmanageable (although there are dedicated software packages that can help to tackle such problems).

Nevertheless, in today's fast-paced and ever-competitive business environment, business strategy calls for rapid product development and the launch of new products to meet the changing demands of consumers. This suggests that effective use of CPA can provide businesses with a competitive edge as they complete designated projects in a timely and cost-effective way. As the example of the Airbus A380 has shown, production delays can severely harm the financial position of a business.

HIGHER LEVEL

Question 56.5 - Sui Yung Webster Inc.

The network diagram below has been created by Sui Yung Webster Inc., an events management company, for a planned outdoor rock concert. Task E cannot start until both C and D (which are independent of each other) are completed. The duration periods are expressed in weeks.



(a) Complete the network diagram for Sui Yung Webster Inc. by calculating the EST and LFT for each activity. *[5 marks]*

(b) Comment on the importance of the dotted arrowed line in the network diagram *[2 marks]*

(c) Evaluate the use of network analysis as a decision-making tool for businesses such as Sui Yung Webster Inc *[10 marks]*

REVIEW QUESTIONS

1. What is critical path analysis (CPA)?
2. Why is project management important to business organizations?
3. What does the process of constructing a critical path analysis involve?
4. In a network analysis diagram, what are dependencies?
5. What are shown by nodes in a network analysis diagram?
6. What do arrowed lines in a CPA diagram show?
7. In a network analysis diagram, how is the critical path identified?
8. What does the EST show and how is it calculated?
9. What is meant by the LFT and how is it calculated?
10. How do the EST and LFT help to identify the critical path for a project?
11. In the context of CPA, what is meant by float?
12. How does the free float differ from the total float?
13. What is the purpose of a dummy activity?
14. What are the main advantages of using CPA as a planning tool?
15. What are the main limitations of using CPA as a planning tool?

HIGHER LEVEL

KEY TERMS

Critical activities are those along the critical path in a network analysis. Any hold-ups to these operations will delay completion of the project.

Critical path refers to the most efficient sequence of activities which minimizes the overall time needed to complete a project. This is shown in a network analysis diagram by double striking ('//') the critical activities.

Critical path analysis (CPA) is a project management planning tool which serves to improve the efficiency of the production process by systematically scheduling tasks and resources to identify the least amount of time needed to complete a project.

Dependencies in a project are the activities that cannot start until the completion of other prior tasks.

Dummy activity is a logical dependency between two indirectly linked tasks in a project. It is used to prevent an illogical path from being followed and is shown by a dotted line in a CPA diagram.

Earliest start time (EST) shows when a particular activity can begin, placed in the top right-hand part of a node. The EST depends on the duration of all previous activities.

Float refers to the spare time (if any) that is available. Activities that have float time can be delayed without affecting the deadline of the project.

The **free float** refers to the amount of time that an activity can be delayed without affecting the EST of the *next* activity in the project.

Latest finishing time (LFT) is the deadline for a particular activity so that the entire project can be completed in minimal time. It is shown in the bottom right-hand part of a node.

Nodes show the earliest start times and latest finish times of each activity within a project. Each node is numbered to identify the sequence of activities in the project.

Project management is the planning and coordination of different jobs and tasks for a particular project. It is especially important when dealing with large assignments and developments.

The **total float** refers to the amount of spare time available to an activity without causing a delay to the overall project.



Figure 56.14 -Critical path analysis is commonly used in the construction industry

Chapter 57
Business Management Toolkit (BMT) 14 - Contribution (HL only)

HIGHER LEVEL

"Price is what you pay. Value is what you get."
- Warren Buffett, CEO of Berkshire Hathaway

Contribution



The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. Contribution is a decision-making tool. The syllabus specifies three types of contribution as part of the toolkit: (i) Make or buy analysis, (ii) Contribution costing and (iii) Absorption costing.

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Contribution refers to the difference between the sales revenue earned from selling a product (its price) and the variable costs of producing the product. Hence, unit contribution is P – AVC, where P = price and AVC = average variable cost (or the variable cost per unit).

A positive contribution exists when there is value added in the production process (see Chapter 1). The financial surplus (positive difference) is then used to 'contribute' to paying towards the firm's fixed costs of production. Recall from Unit 3.3 (Chapter 16) that fixed costs are a firm's expenses that do not change with the level of output, such as rent or interest repayments on bank loans. By contrast, variable costs do change with the level of output, such as the cost of raw materials.

For example, suppose a toy manufacturer has fixed costs of $100,000, an average selling price of $5, variable cost per unit of $2 and sale volume of 120,000 units. From this information, we are able to determine the following:

- Sales revenue = Price × Sales quantity = $5 × 120,000 = $600,000
- Total variable cost = Average variable cost × Quantity of output = $2 × 120,000 = $240,000
- Contribution per unit = Price – Average variable cost = $5 – $2 = $3
- Total contribution = Contribution per unit × Quantity of output = $3 × 120,000 = $360,000
- Profit = Total contribution – Fixed costs = $360,000 – $100,000 = **$260,000**

Contribution analysis can be used as a decision-making business management tool in several ways: (i) make or buy analysis, (ii) contribution costing and (iii) absorption costing.

Make or buy analysis

A **make or buy decision** involves entrepreneurs and decision makers determining whether to manufacture a product in-house or to purchase it from an outsourced third-party supplier. For example, none of the components of the iPhone are made by Apple but outsourced to other companies such as Foxconn and Pegatron, both of which are based in Taiwan.

As an example, suppose that a business can make a product for $22 per unit or it can buy the same product from a supplier for $24 each. Assume that this business has fixed costs of $4,000 per month. The make or buy decision can then be worked out as follows:

- The cost to buy (CTB) outweighs the cost to make (CTM) by $2 per unit, i.e., CTM < CTB or $22 < $24.
- However, the business still has fixed costs of $4,000 per month.
- This means that the business needs to sell at least 2,000 units per month to pay all of the fixed costs.
- Therefore, so long as the business is able to cover all its costs (fixed plus variable costs) per time period, it would be financially sensible for this firm to make the product. However, if sales forecasts are less than 2,000 units per month, it is financially better for the firm to buy this product from a supplier.

In general, if the CTM > the CTB, then it makes financial sense for the business to buy the product from a third-party supplier. The opposite is true if the cost to buy is greater than the firm's cost to make, i.e., the business should manufacture the product in-house). Please see Chapter 40 for more specific information about the cost to make and the cost to buy.

The outcome of a make or buy analysis should be a rational decision that maximizes the long-term financial benefits for the business. Hence, knowledge of contribution analysis can support a firm's internal and external growth strategies (see Chapter 5). However, a make or buy decision is not necessarily made on quantitative grounds.

Figure 57.1 - The make or buy decision is about making a rational choice



Other factors that affect a make or buy decision include both quantitative and qualitative reasons.

- The timeframe in which the products can be produced in-house compared with buying them from an external vendor (seller). If urgent delivery to customers is required, then the business is likely to choose the quickest option, whereas if the order is not urgent the business may choose the relatively cheaper option.
- Spare capacity - Managers and decision makers will need to consider whether the business has sufficient capacity to produce the item in-house or whether it is cheaper and more efficient to use an outsourced supplier.
- Reputation and reliability of outsourced suppliers - The make or buy decision will also depend on whether there is a reliable supplier that can produce the product in sufficient quantities, to the right quality specifications and completed in a timely manner. It is essential the business can work with an external supplier that they can rely on for the long-term.
- Expertise - The business needs to consider whether it has sufficient expertise and know-how to make the item in-house. Essentially, if the product can be made more efficiently by an outsourced supplier, then it would make financial sense to use a third-party provider.
- Fixed costs - The business also needs to consider whether it has funds to purchase the necessary equipment for in-house production. This is a major concern for start-up companies, which tend to lack finance and liquidity. Established firms could think about whether outsourcing the production could allow it to sell existing machinery and equipment so the cash can be used elsewhere.
- An assessment of the firm's core competencies and its non-core activities and functions - For example, suppliers might have specific areas of expertise and access to better technological innovations.
- Strategic importance - Managers and entrepreneurs will need to decide whether the product is part of its core competencies and key to its corporate strategy.
- If the product is vital to the organization, it may convince decision makers to manufacture the product in-house so as to maintain complete control. Conversely, a product that has less significance can more easily be passed onto an outsourced supplier.
- External influences - Factors in the external environment can also have a direct impact on the make or buy decision if an overseas supplier is involved. These factors include the political climate, environmental considerations and fluctuations in the exchange rate.

Contribution costing

HIGHER LEVEL

Question 57.1 - Sami Ikea Inc.

Sami Ikea Inc. is a new business start-up. It can pay $30,000 for specialist machinery in order to have in-house production at a variable cost of $5 per unit of output. Alternatively, Sami Ikea Inc. can use an outsourced supplier that sells these products for $10 each.

Using make or buy analysis, explain whether Sami Ikea Inc. should produce the item in-house or purchase it from the supplier. *[4 marks]*

Contribution costing is a method of valuing costs by allocating direct costs to products or divisions (departments) of a business. Indirect costs (or overhead costs) are not accounted for in this method. For example, suppose a product has a selling price of $8 and direct costs are $3 per unit. The contribution per unit is therefore $5 (selling price minus unit variable costs). Hence, each item sold enables the firm to contribute $5 towards paying its fixed costs. If the fixed costs amount to $5,000 per month, the firm makes a profit once it has sold more than 1,000 units ($5 × 100 units) each month.

Contribution costing also enables a business to set different prices for different products in its portfolio, based on their level of contribution. It can help a business to identify products that are relatively profitable and ones that might need more attention. Consider the data in Table 57.1 which shows how contribution analysis might be used.

Examination of the below data suggests that all six products are profitable because the unit contribution is positive. In general, any product that makes a positive contribution is worth considering as it helps towards payment of the firm's fixed costs (and hence profits). Hence, the sale of each of the above products contributes positively towards the fixed costs of *Café Cuppa*. We can also see:

- The strongest product is the Mocha; despite its relatively high average cost of production, it earns the firm $3.40 contribution per unit sold.
- The most vulnerable product is the Spring water which only earns *Café Cuppa* $1 contribution per unit sold.
- However, it is important to also know the number of units sold before concluding which product is the most profitable.
- Nevertheless, it is clear that twice the number of units of Orange juice needs to be sold in order to earn the same contribution as one unit of Latte.
- Note, as pointed out above, the indirect costs (or overhead costs) of *Café Cuppa* are not accounted for in this method.

Figure 57.2 - Contribution costing is important to account for all costs of production



Table 57.1 - Contribution analysis for Café Cuppa

Product	Cappuccino	Latte	Mocha	English tea	Orange juice	Spring water
Average unit price ($)	5.50	5.75	6.55	3.20	2.55	1.80
Average variable cost ($)	2.25	2.75	3.15	0.95	1.05	0.80
Unit contribution ($)	3.25	3.00	3.40	2.25	1.50	1.00

HIGHER LEVEL

Common mistake

Students who claim that a product should be discontinued or reduced in price (to sell more) because it has the smallest amount of contribution within a firm's product portfolio do not clearly understand this tool. Even the tiniest amount of contribution can be used to pay towards the firm's fixed costs. By contrast, discontinuing the product could mean less total contribution and hence less overall profit for the business.

Contribution costing also considers a firm's **marginal cost**. This refers to the additional costs of producing an extra unit of output. Understanding the marginal cost of production enables a business to set an appropriate price to ensure it makes a positive contribution from the sale of each product. The surplus or positive contribution, is then used to pay towards the fixed or indirect costs of production (see the worked example below).

Exam tip !
Worked Example

The costs incurred by a firm that produces hand-made leather shoes are as follows:

Costs (per pair of shoes)	**$**
Materials	15
Direct labour	20
Indirect costs	10
Total cost (per pair)	45

Calculate the marginal cost of producing an extra pair of shoes.

Answer:

The marginal cost refers to the extra costs incurred by producing an extra pair of shoes. Indirect costs are excluded as they do not relate directly to the actual output of the shoes. Hence, the marginal cost would be $15 + $20 = **$35**. This means the shoes must be sold for more than this price in order for the business to earn any contribution towards paying its indirect costs.

Contribution and contribution pricing (see Chapter 28) are also important for public sector for-profit social enterprises (see Chapter 2). For example, state-owned enterprises are often run as cost or profit centres, holding their management teams accountable for the costs and/or revenues of each public sector company.

However, the main limitation of contribution pricing is that it is not always easy (or objective) to classify costs as either direct or indirect (see Chapter 16).



Figure 57.3 - Is electricity a direct or indirect cost for businesses?

Absorption costing

Absorption costing is an extension of contribution costing. It involves deciding on the most appropriate way to apportion (distribute or share out), a firm's indirect or fixed costs. This helps to ensure that the price covers all costs of production (both the direct costs and the apportioned costs). So, for example, in the case of *Café Cuppa*, suppose the business has fixed costs of $1,200 per month. A simple way to allocate these costs is to split this equally (1,200 / 6 = $200 per product per month) so each product absorbs the same amount of the fixed costs, as shown in Table 57.2.

Table 57.2 - Absorption costing for Café Cuppa

Product	Cappuccino	Latte	Mocha	English tea	Orange juice	Spring water
Average unit price ($)	5.50	5.75	6.55	3.20	2.55	1.80
Average variable cost ($)	2.25	2.75	3.15	0.95	1.05	0.80
Unit contribution ($)	3.25	3.00	3.40	2.25	1.50	1.00
Fixed cost allocation ($)	2,000	2,000	2,000	2,000	2,000	2,000
Break-even quantity	616	667	589	889	1,334	2,000

From Table 57.2, it is then possible to work out the break-even quantity for each product in the *Café Cuppa's* product portfolio:

Cappuccino	= 2,000 / 3.25	= 615.38	= 616 units
Latte	= 2,000 / 3.00	= 666.67	= 667 units
Mocha	= 2,000 / 3.40	= 588.24	= 589 units
English tea	= 2,000 / 2.25	= 888.89	= 889 units
Orange juice	= 2,000 / 1.50	= 1,333.33	= 1,334 units
Spring water	= 2,000 / 1.00	= 2,000	= 2,000 units

Take another example of a toy factory that produces three products: Alpha, Beta and Gamma The producer's total indirect costs are $12,000 per month and additional information is provided below.

Product (Department)	Alpha	Beta	Gamma	Total
Direct costs (per unit)	$8	$5	$6	$19
Floor space (m2)	600	550	350	1,500
Sales volume per month	400	800	600	1,800
Machinery (units)	30	40	30	100

Also, suppose that the toy factory's overheads consist of the following costs:

Rent	$8,000
Marketing	$3,000
Depreciation	$2,000
Total	**$13,000**

- The criterion used to allocate the $8,000 rent could be the floor area occupied by each department. For example, Alpha takes up 40% of the floor area (600m2 / 1,500m2), so it is allocated 40% of the rental costs, i.e., $8,000 × 0.4 = $3,200.
- Similarly, marketing costs could be split according to the sales volume of each product per month. For Gamma, this means it is allocated 33.33% of the marketing costs (600 / 1,8000), i.e., $3,000 × 0.33 = $1,000.
- Finally, depreciation costs could be allocated based on the amount of machinery (units) that belong to each department. For Beta, this means it needs to absorb 40% of the costs of depreciation, i.e., $2,000 × 0.4 = $800.

Using this information, absorption costing can then be computed as follows:

Product (Department)	Alpha	Beta	Gamma	Total
Floor space (m2)	600	550	350	1,500
Rent allocation (A)	$3,200	$2,933	$1,867	$8,000
	3.25	3.00	3.40	2.25
Output (units per month)	400	800	600	1,800
Marketing allocation (B)	$667	$1,333	$1,000	$3,000
Machinery owned by Dept	30	40	30	100
Depreciation allocation (C)	$600	$800	$600	$2,000
Total indirect cost allocation (A + B + C) = D	$4,467	$5,066	$3,467	$13,000
Direct costs (per unit)	$8	$5	$6	-
Sales volume per month	400	800	600	1,800
Total direct costs (E)	$3,200	$4,000	$3,600	$10,800
Total costs (D + E)	$7,667	$9,066	$7,067	$23,800
Cost per unit (Total costs / Sales volume)	$19.17	$11.33	$11.78	-

Whilst absorption costing can be complicated, it makes cost allocation fairer as departments accounting for a larger proportion of specific overheads are apportioned a greater share of the costs. Therefore, the price of each product must be set above its cost per unit in order to earn any profit. This means that the price of each product is determined by the cost per unit allocated to each department:

Table 57.3 - The advantages and limitations of absorption costing

Advantages of absorption costing	Limitations of absorption costing
It acknowledges that using a single criterion to allocate all indirect costs might be too simplistic for multi-product firms.	This method is more complex to calculate than contribution costing, so is more time consuming to compute.
It makes managers more aware of the total costs of a product, helping to ensure that an appropriate price is set to cover all costs of production.	The relative benefits might not be significant to justify its use, especially in the case of smaller firms that lack the time and resources to use absorption costing.
It is seen as a fairer method of allocating costs of different departments as it considers various rates of contribution towards different indirect costs incurred within the organization.	Not all indirect costs can be divided accurately. For example, it might be difficult to apportion the costs of insurance or stationery. Any criterion used is likely to be rather subjective.
The profitability of each product line or department within the business can be examined and measured.	Whichever criteria are used, it is not possible to accurately allocate all indirect costs due to the subjective nature of absorption costing.

Question 57.2

Dolls-R-Us is a manufacturer of toy dolls, with three product lines: Penny, James and Lori. Its annual fixed costs of $85,000 consist of the following:

Rent	$36,000
Administration	$25,000
Depreciation	$12,000
Others	$12,000

Information on the three products is shown below:

	Penny	James	Lori
Selling price	$14	$10	$20
Direct costs per unit	$4	$3	$5
Direct labour costs (p/u)	$3	$2	$5
Sales volume (units)	15,000	15,000	15,000
Number of employees	3	2	3
Floor space (m2)	3,000	3,000	4,000
Value of machinery and equipment	$30,000	$25,000	$35,000

(a) Outline the evidence that suggests Dolls-R-Us has used a cost-plus pricing strategy. *[1 mark]*

(b) Calculate the unit contribution for each of the three products. Show your working out. *[3 marks]*

(c) Explain **three** criteria that would be appropriate in allocating the firm's indirect costs to each of the three products. *[6 marks]*

(d) Use your answer to (c) above to allocate the total fixed costs. Prepare an analysis of the total costs, total revenues and profit for each product. *[10 marks]*

Evaluation of contribution

Contribution analysis has numerous uses for businesses:

- **Pricing strategy** (see Chapter 28) - Contribution analysis helps a business to set prices for each of its products to ensure there is a positive contribution being made towards payment of fixed and indirect costs.
- **Product portfolio management** (see Chapter 47) - The analysis can help managers to decide which products should be given priority for investment. In general, products with a higher total contribution tend to be given precedence. Products that earn a low unit contribution rely on high sales volumes to avoid being withdrawn or replaced by other products in the firm's product portfolio.
- **Make or buy decisions** (see above) - Contribution analysis can help a business decide whether it should produce (make) certain products or purchase them (buy) from suppliers. The relative difference between the unit contribution of making or buying the product is likely to determine the decision.
- **Allocation of overheads to cost and profit centres** (see Chapter 22) - The use of contribution analysis can ensure that cost allocations are done in a fair manner, based on criteria that are clearly communicated to budget holders in advance (see absorption costing above).
- **Special order decisions** - These are a kind of make or buy decision that occur when a customer places an order at a price that differs from the normal price charged by the business. The price could be higher (although the customer will have requested additional features and benefits for

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this, such as shorter delivery times) or it could be lower (probably because the customer is buying a significant amount of the product). Whether the business takes on this special order will largely depend on the total contribution made from such a deal.

- **Break-even analysis** (see Chapter 39) - A business breaks even when neither a profit nor a loss is made. This occurs at the level of output where total costs equal total revenue, i.e., TC = TR. Break-even is a key objective of new and unestablished firms. Hence, businesses need to pay careful attention to their cash flow situation (see Chapter 20) by monitoring and controlling the money coming into the business (revenues) and the money leaving it (costs).

However, contribution is only effective if the data used in the analysis is accurate and up to date. Furthermore, cost allocations need to be done in an open (transparent) and clearly communicated way in order to avoid potential biases that could distort the outcomes of the analysis. Nevertheless, contribution analysis provides managers and decision makers with three broad strategies for improving profits:

- Increasing sales revenue, such as by using appropriate pricing methods (see Chapter 28), improved promotional strategies (see Chapter 29) or growth strategies (see Chapter 5) in order to attract more customers.
- Reducing variable costs, e.g., by seeking more cost-effective production methods, thereby helping to raise the contribution made from selling each unit of output.
- Reducing fixed costs, e.g., negotiating cheaper rents or limiting extravagant company expenses, thereby helping to reduce the break-even level of output.

Key concept

What role should **ethics** play in the allocation of costs to the various divisions of a business?

REVIEW QUESTIONS

1. What is meant by contribution?
2. How is contribution per unit calculated?
3. How is total contribution calculated?
4. What is a make or buy decision?
5. How does the cost to make (CTM) differ from the cost to buy (CTB)?
6. What is contribution costing?
7. What is meant by marginal cost?
8. What is absorption costing?
9. What are the main advantages and disadvantages of absorption costing?
10. How might contribution analysis be of use to businesses?

KEY TERMS

Absorption costing involves deciding the most appropriate way to apportion a firm's indirect or fixed costs between different products and departments of the business to ensure that the price covers all costs of production.

Contribution refers to the difference between the sales revenue earned from selling a product (its price) and the variable costs of producing the product.

Contribution costing is a method of valuing costs by allocating direct costs to products or divisions (departments) of a business.

A **make or buy decision** refers to a situation where a business has to decide whether to manufacture a product or to purchase it from an outsourced supplier, based on comparing the cost to make (CTM) with the cost to buy (CTB).

Marginal cost refers to the additional costs of producing an extra unit of output.

Chapter 58
Business Management Toolkit (BMT) 15 - Simple linear regression (HL only)

HIGHER LEVEL

"Correlations are not explanations and besides, they can be as spurious as the high correlation in Finland between foxes killed and divorces"
- Karl Gunnar Myrdal (1898 - 1987), Swedish economist and recipient of the Nobel Memorial Prize in Economic Sciences (1974)

Simple linear regression

The Business Management toolkit is a set of situational, planning and decision-making tools used to analyse and evaluate the syllabus content as well as being applied in different contexts. Simple linear regression is a decision-making tool. The syllabus specifies three types of simple aggression as part of the toolkit: (i) Scatter diagrams, (ii) line of best fit and (iii) Correlation/Extrapolation.

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Simple linear regression is a statistical tool used to study the nature of the relationships between two variables. One of the variables is the *independent variable* (also known as the *predictor* or *explanatory*) and the other one is the *dependent variable*. For example, businesses might be interested in knowing the relationship between their advertising spending and the impact on the sales of their products. They might also want to see how average incomes in the economy affect the amount of consumer spending.

Given that most new products fail to get established on the market (see Chapter 27), this implies that businesses often over-predict their sales, i.e., sales forecasting (see Chapter 25) is not an exact science and you need to be aware of the limitations. Hence, managers also use simple regression analysis in order to assist in making predictions and strategic decisions.



Figure 58.1 - Statistical tools are used to improve decision-making in the workplace

As a quantitative tool, simple linear regression helps managers and entrepreneurs by tackling issues of complexity, volatility, ambiguity and uncertainty which are all associated with business decision making. The IB syllabus specifies three types of simple aggression as part of the BMT: (i) scatter diagrams, (ii) the line of best fit and (iii) correlation/extrapolation.

(i) Scatter diagrams

Scatter diagrams are a statistical visual tool that can be used to show relationships between two different variables in a data set, such as advertising spending and sales revenue. A scatter diagram consists of data points that plot the values of one variable on the x-axis (such as academic qualifications) and the

other variable on the y-axis (such as the amount or value of an employee's salary).

Relationships in a scatter diagram can fall into three categories:

- A positive correlation means the two variables move in the same direction in a scatter diagram, such as the demand for complementary goods like shoes and socks or tennis racquets and tennis balls.
- A negative correlation means the two variables move in the opposite direction in a scatter diagram, such as in the case of substitute products, e.g., the price Coca-Cola and the demand for Pepsi Cola.
- There is no correlation between the two variables if the data sets do not show a positive or negative correlation, such as the age of employees in an organization and how far they have to travel in order to get to work.

In general, there are five types of patterns that tend to arise from scatter diagrams, with the following descriptions for each. In Figure 58.2, the data points are depicted as clouds for illustrative purposes.

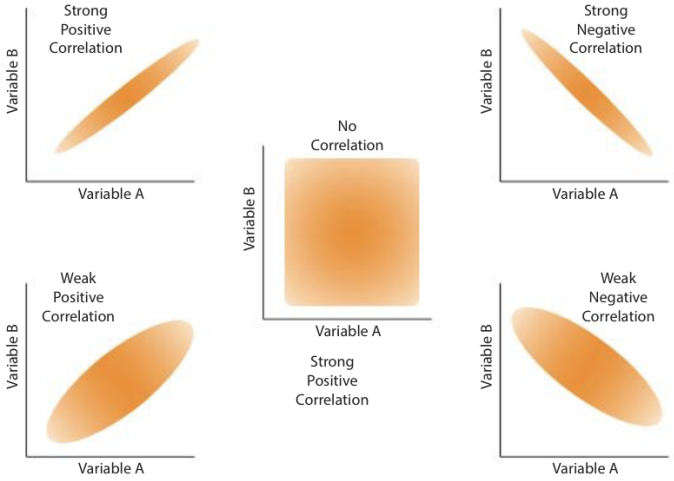
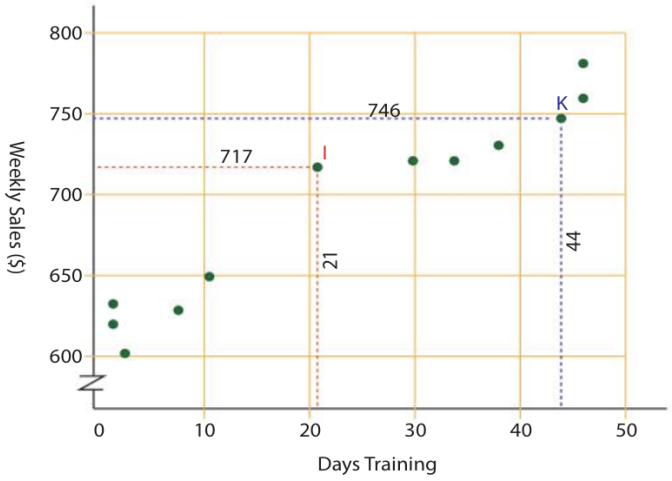


Figure 58.2 - Types of correlations shown in scatter diagrams

As an example, suppose that the director of a business with 12 employees wants to know whether the company's staff training programme is improving sales performance. The information needed for each employee in order to plot a scatter diagram for this purpose are the number of days spent on training and the weekly sales from each employee in the subsequent time period.

The raw data, even when presented in a table, does not tell us much – we need a scatter diagram as a visualization. This plots the data points on a Cartesian (XY) graph. Each employee has one point on the scatter diagram. For example, employee I is shown by the coordinates (21,717) and employee K is represented by the coordinate (44,746).

Employee	A	B	C	D	E	F	G	H	I	J	K	L
Days training	38	46	2	34	8	11	2	46	21	3	44	30
Weekly sales ($)	730	759	631	721	628	648	619	781	717	601	746	720



Note that the vertical axis does not start at zero (see the labels and the "Z" symbol). This is to enable the pattern to be more obvious. The pattern of the data points in the above scatter diagram suggests there is a positive correlation between the number of days spent training and the associated sales performance. Hence, the diagram suggests the two variables are related to one another or co-related and that there is some evidence so suggest that the training programme is effective.

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Question 58.1

Dina Yammout is the Human Resources Manager for a retailer that sells clothes. She has compiled the following data which shows the number of employee days lost to illness per month and the average daily temperatures (degrees Celsius) on those months.

Month	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Temp	2	3	7	13	19	23	24	29	20	15	11	9
Days off	56	41	50	35	42	22	35	11	40	28	45	17

(a) Use the data above to plot an appropriate scatter diagram. *[4 marks]*

(b) Comment on the findings shown in your scatter diagram. *[2 marks]*

Question 58.2

The data below summarizes the data for 10 different IB World Schools. It shows the number of years that each school has offered the IB Diploma Programme and the average IB score (out of 45 points) in each of these schools.

School	A	B	C	D	E	F	G	H	I	J
Years of IB experience	2	8	7	13	5	6	10	7	8	15
Average IB score	27	38	38	35	29	35	36	32	40	38

(a) Use the data above to plot an appropriate scatter diagram. *[4 marks]*

(b) Comment on the findings shown in your scatter diagram. *[2 marks]*

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(ii) Line of best fit

A **line of best fit** (also known as the **regression line**) is a statistical technique that involves calculating and drawing a straight line that goes roughly through the middle of all the points on a scatter diagram. The line of best fit helps to express the relationship between the two variables shown in the scatter graph. The closer the scatter points are to the line of best fit, the stronger the correlation is between the two variables and vice versa.

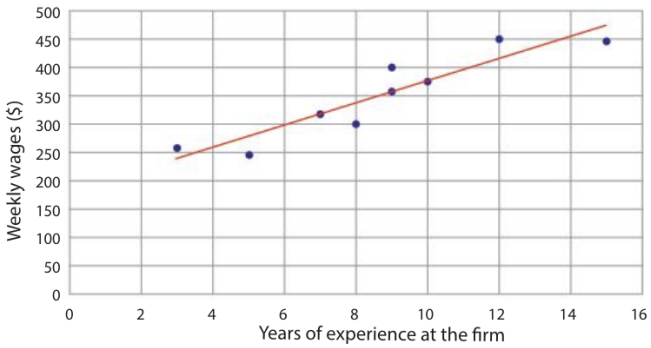
The line of best fit (or trend line) can be derived using algebraic equations, but in most cases, it is sufficient to get an approximation by drawing a line that seems to best show the relationship shown in a scatter diagram. A 'good' line of best fit may not always go through any of the data points but will usually have as many points below as it has above. In the real world, graphic display calculators and spreadsheets use algorithms to work out and construct the line of best fit.

A strong correlation exists if the data in a scatter graph do not deviate from the line of best fit by very much; the closer the data points are to the regression line, the stronger the relationship between the two variables being investigated. A moderate correlation (positive or negative) exists if a line of best fit can be determined but the data points are not always closely aligned with the regression line.

The data below show the weekly wages for nine employees at a firm. Tthe manager would like to know whether there is a correlation between employee loyalty (based on the number of years of experience at the organization) and the income received by workers.

Employee	A	B	C	D	E	F	G	H	I
Years at firm	5	9	12	8	7	9	10	15	3
Income ($ p/w)	250	360	450	300	320	400	380	450	260

Without a visual scatter graph, it is difficult to comprehend whether there is any correlation between the two variables shown above. plotting the data in a scatter diagram enables the manager to determine a line of best fit and to see the extent to which a relationship exists:



From the line of best fit, the manager can see the approximate value of an employee's weekly wages based on the number of years that they have been with the firm. For example, the line of best fit (shown by the red linear line) shows that an employee with six years of experience at the firm will earn around $300 per week whilst someone with 11 years of experience will earn about $400 per week.

Recall that the line of best fit is drawn in such a way that all the data points are evenly distributed on either side of the straight line. It is not necessary for IB business management students to construct the line of best fit precisely using an equation. Instead, you will be expected to show the line of best fit by drawing an approximate but visually realistic interpretation of the line.

Exam tip !

When drawing the line of best fit, make sure you use a transparent ruler to ensure the line fits between all the data points before you draw it. Also ensure the line of best fit is linear.

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Question 58.3

The data below represents information for 9 companies competing in the same industry. All figures are in $ million for the previous tax year.

Company	A	B	C	D	E	F	G	H	I
Sales revenue	120	50	300	130	250	170	110	130	160
Charitable donations	1.2	0.75	3.0	1.3	3.2	2.21	1.54	0.65	1.6

(a) Using a scatter diagram, plot the data to show each firm's sales revenue on the x-axis against the amount the company donated to charities on the y-axis. *[4 marks]*

(b) Draw an appropriate line of best fit on your scatter diagram. *[1 mark]*

(c) Use the line of best fit to predict the amount of charitable donations made by a company operating in the industry that earned $275 million in sales revenue. *[1 mark]*

(d) With reference to your scatter diagram and line of best fit, distinguish between a weak and a strong correlation in a data set. *[4 marks]*

(iii) Correlation/Extrapolation

Correlation indicates the extent to which there is a relationship between two variables or events, such as sales revenue for a product and different seasons of the year or the amount of marketing expenditure and market share. So, for example, if marketing executives and managers can identify a correlation between advertising expenditure and consumer spending on a particular good or service, they can take advantage of this knowledge in order to further improve sales and ultimately profits.

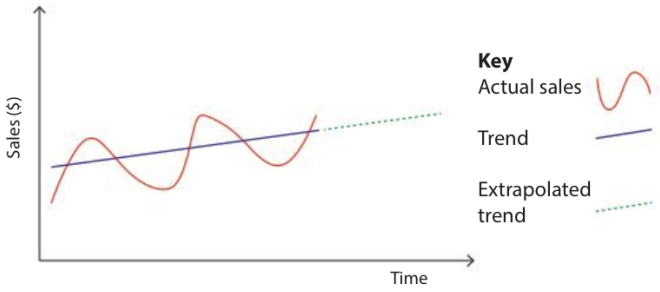

Figure 58.3 - Extrapolation of sales trend

Extrapolation is a statistical technique that enables managers to estimate data values beyond the original data set used as the basis to determine the type of correlation. Extrapolation takes the line of best fit one step further in simple linear regression and is used as a prediction tool, as illustrated in Figure 58.3.

This forecasting technique identifies the trend by using past data and extending this trend to predict future sales. For example, if a firm's sale revenues have increased by an average of 5% each year for the past several years, then it might be expected that this trend continues in the near future. Graphically, the trend can be shown by a line of best fit and extrapolation simply extends this line to make predictions. Extrapolation works well if there is a clear and strong correlation (relationship) between two data sets.

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However, correlation differs from **causation**, which indicates that the occurrence of one event (such as greater expenditure on staff training) has caused the occurrence of a second event (such as improved productivity in the workplace). Whilst correlation can explain causation, this is not necessarily the case. As an example, statisticians have discovered that as ice cream sales in Australia increase, the rate of shark attacks also increases dramatically. However, this does not mean that ice cream sales cause shark attacks - this would not make logical sense. Statisticians explain this by going beyond the data showing that on hotter days more people buy ice cream as well as spending more time swimming in the sea so may be more prone to shark attacks.

Box 58.1 - Correlation, Causation or Coincidence?

- Vox Media reported that American residing in large cities like Los Angeles and San Francisco in California live longer.
- The Journal of the American Medical Association (JAMA) reported that Americans with higher incomes have longer lives on average.
- The New York Times reported a study that showed sleeping in a room with a fan lowered a baby's sudden infant death syndrome (SIDS) by 72%.
- Reuters Health reported that elderly people in the UK with tooth loss are three times more prone to memory loss caused by dementia.
- The guardian newspaper reported that a study showed feeding children with a healthy diet rich in fish could prevent anti-social and violent behaviour in their teen years.
- The Harvard Business Review showed a close correlation between the number of visitors to Universal Orlando's "Islands of Adventure" theme park with the sales of new cars in the US.
- The US Department of Agriculture and National Science Foundation revealed a 95.86% correlation between the consumption of mozzarella cheese and the number of Engineering Doctorate (EngD) qualifications awarded.
- Data from US Census and United States Department of Agriculture showed a 99% correlation between the consumption of margarine and the divorce rates in the state of Maine.

Exam tip !

For IB assessment purposes, the line of best fit should be drawn through the scatter data points in a scatter diagram to express the relationship between two variables. You will not be expected to calculate the line of best fit (regression line). Importantly, simple linear regression is used as an estimation tool by managers, such as using the line of best fit in a scatter diagram to extrapolate (or predict) future outcomes.

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Exam tip !

Remember that a correlation only shows if there is a relationship between two variables in a data set. It does not provide any insight into why such a relationship might exist. Furthermore, correlation does not allow us to go beyond the data that are given. Therefore, as with all quantitative techniques in Business Management, be careful with how you use data and interpret the findings.

Exam tip !

For IB assessment purposes, be prepared to comment on the nature of the correlation by using a line of best fit. You will need to comment on whether the data show there is a positive, negative or no correlation between the variables.

Theory of Knowledge (TOK)

Is the ability to predict essentially the same as the ability to know? Does knowing allow us to predict?

Theory of Knowledge (TOK)

Is there anything that money cannot really buy? Can money buy time and healthcare, for example?

Evaluation of simple linear regression

As with any quantitative or statistical tool, the benefits of using simple linear regression will depend on the validity of the data collected and used to calculate correlations and trends. Whilst linear regression can help to minimise the risks of decision making, you need to be aware of the potential limitations behind the data. In particular, the line of best fit can be easily distorted by random variations and outliers in data sets (see Box 58.2). The prolonged COVID-19 pandemic, for example, will have distorted data sets for businesses across all industries in every part of the world. Seasonal fluctuations in demand for certain goods and services can also create challenges in determining relationships and correlations (see Box 58.3).



Figure 58.4 - The COVID-19 pandemic has made linear regression analysis less reliable

Box 58.2 - Examples of random variations and outliers

- Economic recessions and slumps that can last for several years.
- Labour unrest, such as strike action (see Chapter 13).
- Mass-scale product recalls due to safety concerns (see Chapter 37).
- Natural disasters, such as hurricanes, flooding and earthquakes.
- Outbreak of a war.
- Outbreak of infectious diseases.
- Political turmoil and public disorder.
- Public relations disasters.
- Unexpected, severe, adverse weather conditions.

Box 58.3 - Examples of seasonal demand

Seasonal fluctuations in demand are caused by variations in the demand for certain goods and services during different time periods. For example, they can be caused by changing seasons in the year or religious festivals such as Christmas, Easter, Diwali, Ramadan and Lunar New Year. Examples of goods with seasonal demand include:

- Clothing (winter and summer)
- Easter eggs
- Fireworks
- Flights (during school holidays)
- Gift cards, e.g., Mothers' Day cards or Valentine's cards
- Sun lotion
- Sunglasses
- Textbooks.

Finally, it is important to remember that correlation does not always imply causation, irrespective of what the linear regression data might show. After all, a set of data conceals as much information as it reveals.

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REVIEW QUESTIONS

1. What is meant by simple linear regression?
2. How does an independent variable differ from a dependent variable?
3. What is a scatter diagram?
4. How does positive correlation differ from negative correlation?
5. In the context of linear regression, what is meant by correlation?
6. What is meant by extrapolation?
7. How does correlation differ from causation?
8. What is meant by the line of best fit?
9. How does a strong line of best fit help with making extrapolations?
10. How might random variations affect the results of linear regression?



Figure 58.5 - Businesses are increasingly relying on data and simple linear regression techniques to inform decision making

KEY TERMS

Correlation indicates the extent to which there is a relationship between two variables or events e.g., the amount of marketing expenditure and market share.

Extrapolation is a statistical technique that enables managers to estimate data values beyond the original data set used as the basis to determine the type of correlation.

A **line of best fit** is a statistical technique that involves calculating and drawing a straight line that goes roughly through the middle of all the points on a scatter graph. It is used to determine the relationship, if any, between two variables under investigation.

Scatter diagrams are a statistical visual tool that can be used to show relationship between two different variables in a data set.

Simple linear regression is a statistical Business Management tool used to study the nature of the relationships between two variables.

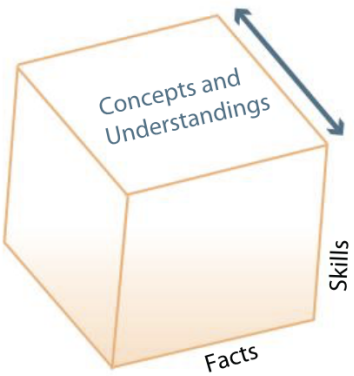
Chapter 59

Introducing the key concepts in Business Management

"The world is moving at a tremendous rate. Going no one knows where. We must prepare our children, not for the world of the past. Not for our world. But for their world. The world of the future."
- John Dewey (1859-1952), American educational leader, philosopher and psychologist

What is concept-based learning?

Concept-based learning (CBL), as defined by education consultant Dr. H. Lynn Erickson, is of learning that frames **facts** (content) and **skills** with key **concepts** and understanding in the Business Management course. The rigour of the course creates two approaches to teaching and learning: either students can be told what they need to know (based on factual knowledge and skills in Business Management) or teachers can get their students excited enough to discover and deepen their understanding of Business Management for themselves.



Concepts are large, interdisciplinary ideas that have relevance both within and across academic subject areas. They help to move students from content-based knowledge to deeper understandings by using conceptual lenses that facilitate the transfer of knowledge across subject content and contexts. The IB uses a concept-based approach to teaching and learning. In Business Management, the four prescribed concepts are **change**, **ethics**, **sustainability** and **creativity**.

The 21st Century learner lives in a mobile and digital world with access to growing facts and information at their fingertips. As educators, we cannot expect our students to learn (just) more content knowledge in Business Management. Instead, we have to help students to connect the factual knowledge to more permanent (timeless) and interdisciplinary concepts to advance their knowledge and understandings. In Business Management, concepts are used to give students the tools necessary to make sense of the world. Supporters of CBL argue that it is through these conceptual lenses that learning truly begins to make sense for students.

Concept-based learning is not about learning facts and figures in isolation. Instead, it is about encouraging students to:

- Think beyond the factual contents of the Business Management course.
- Be active learners rather than passive learners (for example, there is huge scope in Business Management to use inquiry to engage students in their learning).
- Be inquiring and curious learners who want to further their understanding and knowledge (such as through the use of real-world case studies that students are interested in).
- Make connections of knowledge in Business Management to the key concepts as transferable ideas or lenses across all topics in the course.
- Apply their knowledge and thinking to solve problems using an organized framework (the four key concepts of change, creativity, ethics and sustainability).
- Use multiple sources and media to gain and extend knowledge and understanding, as well as to recognise the transferability of knowledge to familiar and unfamiliar situations.

- Think critically and creatively to solve problems.
- Discuss and collaborate with peers to progress their own learning.
- Organise and make sense of their own learning.
- Own and drive their own learning in a synergistic way.

Hence, CBL can help students to broaden their knowledge and understanding of the world around them (see Table 53.1). Essentially, concept-based teaching and learning are integral to the IB's teaching and learning pedagogy

Table 53.1 - Knowledge vs Understanding

Knowledge	Understanding
Factual awareness, connected to a particular time, place or situation. Knowledge changes over time.	Conceptual appreciation of factual knowledge that transfers through time and across situations and cultures. Concepts are timeless.
Example: According to F.W. Taylor (1911), people are motivated by money, so scientific management can be used to create a one 'best way' to increase labour productivity.	There is no single way to motivate all people all of the time in all situations across all cultures. Change and ethical considerations can bring about positive and negative impacts on motivation and labour productivity.
Example 2: Budgets can be used as a control tool to ensure managers are held accountable for their activities and team performance.	Budgets can constrain creativity and innovation yet are shaped by the culture of the organization and are vital to its sustainability and strategy.

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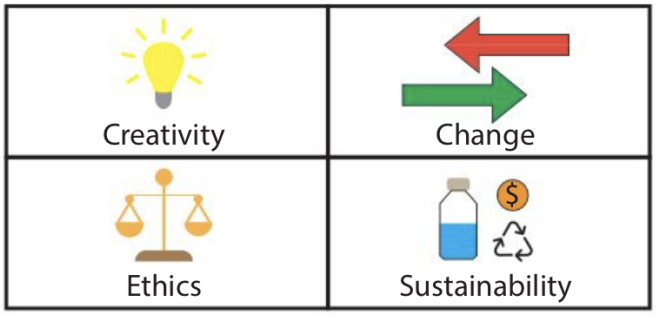
Supplementary information

Exam tip !

For definitions and examples of how the four key concepts can be used in Business Management, refer to pages 14 - 15 in the syllabus (Guide).

Concept-based learning in Business Management



The traditional curriculum is designed to be 'topic based' (or content based) rather than 'concept based'. However, critics of a content-based curriculum argue that the model is outdated (just ask Google!) and does not encourage the 21st Century learner to develop personal intellect. CBL is ideal for the Business Management course as it promotes a more holistic approach in order to create a deeper understanding of the subject content and contexts. The key concepts create four **conceptual lenses** through which students (and teachers) investigate, analyze and evaluate factual content to create a deeper understanding of Business Management in different contexts.

One of the arguments in favour of a CBL approach to BM is that a content-driven syllabus, which requires students to memorise facts and information, rarely engages learners or challenges their thinking. Students who are personally and intellectually engaged are far more likely to be motivated to learn. Compare the different experiences for learners who face 'chalk and talk' lessons on the following topics (in an abstract and non-engaging way) compared to using a CBL and inquiry approach:

- Business organizations (Unit 1.2) - Students can gain hands-on experience in setting up and running a business organization by being involved in educational programmes outside of the classroom such as Young Enterprise (www.young-enterprise.org.uk) or the Junior Achievement Company Programme (www.juniorachievement.org).
- Teamworking as a form of non-financial motivation (Unit 2.4) - Students can get more engaged in their learning and understanding of how teamworking can apply as a form of motivation by taking the Marshmallow Challenge (http://goo.gl/rcp1).

- The marketing mix (Unit 4.5) - Students can be challenged in their personal learning and application by being involved in an interschool marketing competition (http://goo.gl/dC8Kv5).

The above activities are also great for incorporating all five of the approaches to learning (ATLs), namely research, communication, thinking, social and self-management skills.

Another way to view CBL in Business Management is to use the **triangulation model**. This consists of the **content** of the syllabus, integrated with appropriate case studies from the business world to provide a **context** to the learning and embedded in **concepts** to transcend understanding of Business Management. An example of a classroom activity that embraces these building blocks is to get students to investigate how marketing strategy is influenced by change, ethics, sustainability and creativity for an organization of their choice.

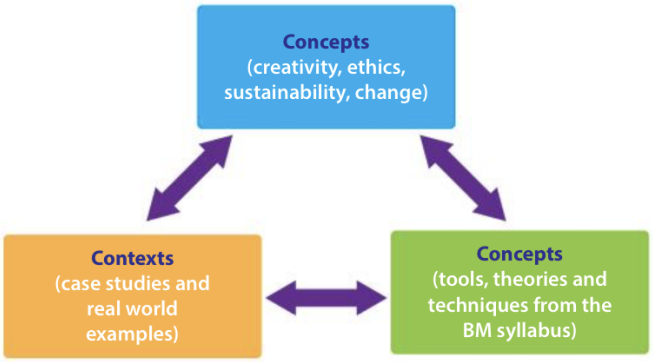


Figure 59.1 - The triangulation of building blocks in Business Management

Theory of Knowledge (TOK)

If it is not possible to teach everything that is important, how do we know what is actually worth teaching?

The key concepts and inquiry questions

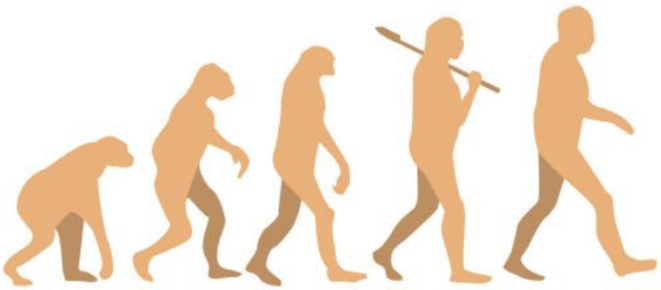
Examples of the types of inquiry-based questions to consolidate understanding of content, contexts and concepts include:

- With reference to an organization of your choice, examine how **creativity** and **ethics** influence promotion in the marketing mix.
- With reference to an organization of your choice, examine how **ethics** have brought about a **change** in human resource management.
- With reference to an organization of your choice, discuss the importance of **change** and **sustainability**.
- Examine how the concepts of **creativity** and **ethics** have influenced the extended marketing mix for an organization of your choice.
- With reference to an organization of your choice, compare and contrast the importance of **creativity** and of **change**.
- With reference to an organization of your choice, examine how **ethics** may influence approaches to **sustainability**.

Using the key concepts in Business Management

Change

"When you're finished changing, you're finished."
- Benjamin Franklin (1706–1790), one of the Founding Fathers of the United States of America



Change can be expressed as a conversion, transformation or movement from one form, state or value to another. The concept can be explored throughout the course, from multiple perspectives as businesses operate in a dynamic world that is subject to frequent and continual change. Inquiry into the concept of change involves understanding and evaluating causes, methods and consequences of change itself.

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Supplementary information

Supplementary information

Due to increasing competition, new technologies and markets as well as changing trends in consumer behaviour, business organizations need to adapt their objectives, strategies and operations if they are to succeed. This success emerges from their ability to research and respond to signals in both the internal and external environment. American novelist, Ellen Glasgow (1873 - 1945) said that "*All change is not growth, as all movement is not forward.*" In other words, change should only be pursued if there is a clear purpose. Force field analysis (see Chapter 55) examines two different forces of change.

Driving forces push for change whilst **restraining forces** act against change. Due to the conflicting forces, change must be managed within organizations if they are to move forward and remain competitive, such as funding relevant training programmes for employees (see Chapter 10). The relative strength of these forces determines whether the change should take place.

Before instigating any aspect of organizational change, managers must ask themselves:

- Why is change needed?
- What do we hope to achieve with such change?
- Who is affected by this change and how are they likely to react to the change?
- How will we know that the change has been successfully implemented?

This set of questions is reoccurring as businesses continually face change. A popular management tool to aid this process is **force field analysis** (see Chapter 55) which acts as a framework for helping managers to understand the pressures for and against any change situation. By identifying these forces, managers are able to assess the effects that the forces may have and to decide on a course of action. Managers can then plan to strengthen the driving forces supporting a decision for change and reduce the impacts of the restraining forces that oppose it (see Figure 59.2).

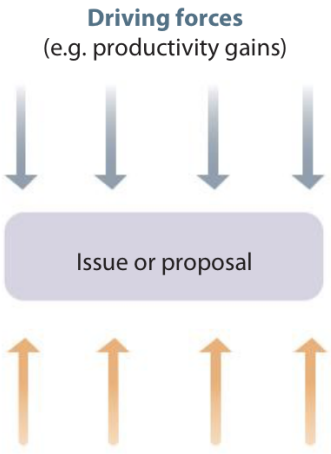

Figure 59.2 - Forces of change

There are usually four phases of change (FRIA), all of which need to be managed, although to varying degrees:

- **F**ear of the unknown.
- **R**ejection due to misunderstandings of the need or purpose of change.
- **I**nterest (buy-in or support from the staff).
- **A**cceptance of the need for and purpose of change.

Case study 59.1 - Name change

Businesses that have changed their names include LG Electronics (formerly Lucky and GoldStar). Nissan was originally Datsun. AuctionWeb became eBay. Pete's Super Submarines became Subway. Dell Computers was originally called PC's Limited. Relentless.com became Amazon. Computing Tabulating Recording Corporation was rebranded as IBM. Pepsi was called Brad's Drink. Nike started off as Blue Ribbon Sports. Firebird became Firefox. And Google was originally called BackRub!

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Case study 59.2 - Kodak

Kodak was once the world's largest supplier of photographic camera film but was too slow to switch to digital technology in the late 1990s. Founded in 1888, Kodak dominated throughout most of the 20th Century, with its market share peaking at 90% in 1976. However, Kodak's inability to make profit for five consecutive years meant the company stopped production of digital cameras and filed for bankruptcy in 2012.

Case study 59.3 - Blockbuster

Blockbuster was a multinational company founded in 1985 and provided home entertainment rental services, such as DVD movies and video games. At its peak in 2004, the American company employed over 60,000 people in 9,000 stores across the world. Its failure to adopt internet technologies and to diversify, plus the competition from rivals such as Netflix and Amazon, led to Blockbuster's bankruptcy in 2010. Whilst acquisitions enabled the business to continue its operations for a little longer, albeit on a much smaller scale, the company closed its remaining 300 stores in November 2013!

Case study 59.4 - Nokia

Nokia was founded in 1865 – about 125 years before the commercialization of the mobile phone. The Finnish company started by manufacturing paper in its pulp mills in various locations, including the town of Nokia. The company diversified into rubber manufacturing before switching to electronics. At its peak, Nokia had 62.5% market share before Apple launched its iPhone 3G in 2008. Fierce competition from Apple and Samsung forced Nokia to be sold to Microsoft for 5.4bn euros ($7.2bn) in 2014, following a drop in its market share to just 3%.

Ethics

"You cannot make yourself feel something you do not feel, but you can make yourself do right in spite of your feelings."
- Pearl S. Buck (1892 - 1973), American writer and novelist



Figure 59.3 - Is it ethical to deliberately hire cheap labour?

Ethics are the socially accepted moral principles that guide decision-making, based on the society's collective belief of what is right and what is wrong. The rather subjective nature of ethics means it is not always clear what is 'right' or 'wrong', especially when looking at different cases from around the world. Consider the five examples below and discuss the extent to which you think each case is ethical.

- In 2013, Gareth Bale (aged 24 then) became the world's most expensive football player having switched from London's Tottenham Hotspur to Spain's Real Madrid, who paid a world record 100 million euros ($137.7million) for his services in a contract up to 2019. Bale's weekly wages were reported to be around $413,000, i.e., $59,000 a day or over $40 every minute, even when asleep! The UK Prime Minister's daily salary is around $622.

- In 2017, Serena Williams was the only female featured in Forbes' list of the 100 highest paid sports stars. In 2018, for the first time ever, no females made the list, despite global pressures and support to close the gender pay gap.

- In 2018, *The Wall Street Journal* reported that Walmart's CEO was paid a staggering 1,188 times more than the median salary of employees at America's largest retailer. Can such huge wage differential be truly justifiable?

- It was not until 2018 that women in Saudi Arabia were permitted to attend football (soccer) matches. In the same

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year, Saudi women were allowed to drive for the first time in the country's history.

- In 2022, Novak Djokovic was deported from Australia as he had not been vaccinated for the COVID-19 coronavirus. The world's number 1 tennis player was unable to defend his title at the Australian Open that year, resulting in several high-profile corporate sponsors ending their contract with the tennis star.

Consider these questions based on business ethics. What are your opinions about each of these?

- Should a business monitor the online activities, including email communications, of employees? Is digital Taylorism (see Chapter 43) unethical and an invasion of privacy?



Figure 59.4 - Are surveillance systems an infringement of privacy laws?

- Is it possible to simultaneously achieve equity and equality in the workplace?
- Should the business of beauty pageants (such as Miss World or Mr. Universe) be banned?
- Is it right for a business to fabricate its financial accounts if this prevents huge job losses?
- Can taking the credit for the work of others ever be morally acceptable?
- Can acting unethically ever be 'good' for a business?
- Does acting ethically hinder creativity and innovation?

ATL Activity 59.1 (Research skills))

Which multinational companies do you think are the most ethical? Have a look at the Ethisphere website, which compiles an annual league table of the world's most ethical businesses: http://www.worldsmostethicalcompanies.com/honorees/. Investigate the criteria used to compile this list

Theory of Knowledge (TOK)

If ethics are based on a set of beliefs of what is morally right or wrong, can we ever really 'know' what is right or wrong?

Theory of Knowledge (TOK)

How can we know if there is anything unethical about the operations of charitable organizations?

Note: this textbook is not available as a PDF document – so if you are using a soft-copy, not only is this unethical, but it is also a breach of international copyright laws.

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Supplementary information

Sustainability

"We need to think of the future and the planet we are going to leave to our children and their children."
- Kofi Annan (1938 - 2018), Ghanaian diplomat

The United Nations (UN, 1987) explains the concept of **sustainability** as "meeting the needs of the present without compromising the ability of future generations to meet their own needs". Business activity has an important role in ensuring sustainability by creating a balance between the ecological, social and economic needs of people today and those of future generations. For example, this might include the use of green technologies and circular business models (see Chapter 51).

Sustainability is a concept which promotes intergenerational equity, i.e., production enables consumption of goods and services for the people of today without compromising the consumption for the people of tomorrow. It is about meeting the needs of the current generation in such a way that it does not jeopardize the needs of future generations.

There has been growing interest in the reporting of the **triple bottom line** (TBL or 3BL) in for-profit, non-profit and government organizations. The triple bottom line provides a framework for sustainable business activities, founded on three 'pillars' (see Figure 35.4). Increasingly, businesses report more than just their profits (the traditional 'bottom' line) and choose to also report on their impact on the planet (ecological sustainability) and people (social sustainability). The TBL was coined by John Elkington in 1994, a British and internationally renowned author of sustainability.

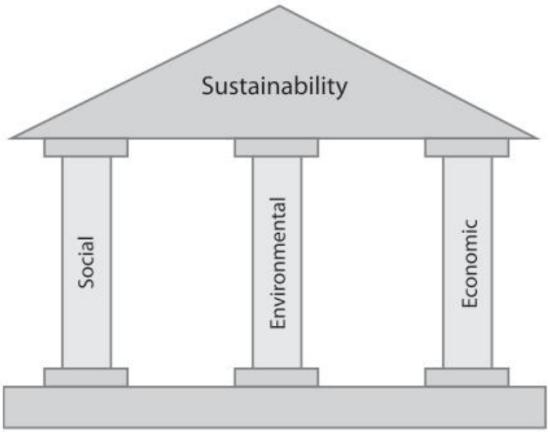

Figure 59.5 - John Elkington's pillars of sustainability (1994)

Ecological sustainability

Ecological sustainability refers to the capacity of the natural environment to meet the needs of the current generation without jeopardizing the ability of future generations to meet their needs. For example, overfishing or the continual destruction of rain forests are not ecologically sustainable. A lack of ecological sustainability means that production can exhaust (deplete) the earth's natural resources for future generations. Ecological sustainability requires efficient and sensible use of the world's scarce resources so that they do not become overly exploited or depleted.



Figure 59.6 - Ecological sustainability involves efficient waste management

The world's population reached one billion people in 1804. It reached 2 billion by 1930 (around 126 years later). However, with improved standards of living, the global population reached 3 billion just 30 years later in 1960. It has since more than doubled to over 7 billion (this milestone was reached in 2011). The UN estimates the world's population will rise to 8.5 billion by 2030. Clearly, such exponential population growth puts huge pressures on the world's scarce resources. This makes ecological sustainability a key priority for many businesses. Hence, ecological sustainability requires businesses to consider more environmentally friendly practices, such as those in Box 59.1.

Box 59.1 - Examples of ecologically sustainable business practices

- **Green technologies** - Environmentally friendly innovations that consider long-term impacts on the natural environment, e.g., renewable energy systems such as solar panels and wind turbines.
- **Recycling** - This is about turning waste products (such as glass bottles) into reusable materials. It is the process of making new products from those that have already been used for another purpose.
- **Ecological footprint** - This measures the impact of resource consumption and waste production on the natural environment. It assesses whether people are living beyond the capacity of the planet, e.g., the proportion of the population that drive.
- **Cradle to cradle production** - Putting an end to traditional single-use manufactured products ('cradle to grave') by creating products that can be easily recycled and re-used (see Chapter 37).
- **Conservation** - Using the planet's finite resources in a sustainable way by using renewable resources (such as trees and fish) at a rate that enables these resources to self-replenish. It is also about reducing the reliance and overuse of non-renewable fossil fuels, such as coal and oil.
- **Preservation** - This is about protecting the earth's resources by reducing the human impact on the physical environment (e.g., national parks), the natural environment (e.g., rainforests) and the cultural environment (e.g. ancient civilization and heritage sites).



Figure 59.7 - Preservation of heritage sites are important aspects of ecological sustainability

Social sustainability

The social pillar of sustainability examines social interactions and structures that are necessary for sustainable development, i.e., it is the ability of the society to develop in such a way that it meets the social well-being needs of the current and future generations. For example, the world's population continues to grow at an increasing rate (see Box 59.2), resulting in greater levels of consumption and depletion of the planet's natural resources.

Social sustainability enables society to optimize the quality of life for people and their descendants. By contrast, social barriers prevent a community from advancing, e.g., poverty, unemployment and social exclusion (including racial discrimination and gender inequalities). Male business leaders need to accept women as equals if there is to be social sustainability and development. South African President Nelson Mandela (1994-1999) said "*for every moment we remain silent, we conspire against our women.*"

Indeed, embracing social justice can bring many business opportunities in terms of improved recruitment, retention and reputation. Gender discrimination (see Box 59.3) represents an inefficient allocation of human resources for society as a whole. By contrast, gender equality is fundamental to both economic and human development. From a humanitarian viewpoint, removing social inequalities gives communities a better chance of achieving sustainable development goals.

Box 59.2 - World population milestones

8 billion: 2022

7 billion: 2011

6 billion: 1999

5 billion: 1987

4 billion: 1974

3 billion: 1960

2 billion: 1930

1 billion: 1804

Source: http://www.worldometers.info/world-population/

A key social role of businesses is job creation, thus directly helping to foster economic and social prosperity. In addition to creating jobs and paying taxes, many countries expect businesses to fulfil their corporate social responsibilities (see Chapter 3). Not doing so can attract unwanted negative media publicity. Hence, an increasing number of businesses apply corporate social responsibility (CSR) in their policies and practices. Being socially responsible means the business consults with its internal stakeholders (such as employees and shareholders) and external stakeholders (such as customers, suppliers, the local community and the government) in order to determine their social priorities.

Theory of Knowledge (TOK)

If there is no universally agreed definition of 'human rights', can this ever be achieved globally for social sustainability?

Theory of Knowledge (TOK)

Can gender equality and morality ever be mutually exclusive? Are the concepts of equity and diversity incompatible in society?

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Box 59.3 - Gender inequalities

- According to the United Nations (UN), discrimination against women and girls is the most persistent form of inequality.
- According to the Australian government, two-thirds of the 800 million people in the world who lack basic literacy skills are female.
- Estimates from the UN Development Programme show that in South Asian countries, like India and Pakistan, fewer than 35% of women do paid work.
- Cambodia, China and Vietnam do much better with nearly 70% of women in paid work – well above the global average of 53%.

Economic sustainability

Economic sustainability refers to business activities that meet the economic needs of the present generation, using the existing resources that are available, without compromising the ability of future generations to meet their own needs. It requires production managers to consider which resources (land, labour, capital and enterprise) are not used efficiently in order to correct the situation.

More of a threat to economic well-being is the overuse of resources that makes it increasingly more difficult to sustain the output of goods and services over time. For example, the use of fossil fuels as energy sources (e.g., coal, oil and natural gas) has huge repercussions on the natural environment, including climate change.

The rapid economic development in Vietnam and India, for example, has resulted in high levels of pollution and damage to the natural environment. Globally, economic activity has led to the rapid depletion of the world's finite resources, especially

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non-renewable resources. With the continual rise in world population growth, the question for businesses is whether economic growth and its associated impact on the natural environment is sustainable.

Common mistake

Some students comment that achieving zero emissions (pollution) is the solution to economic and social sustainability. This is impractical as the only way to ensure zero pollution is to have *no* output! Sustainability is about managing operations in such a way that businesses can still thrive in the future.

Economic sustainability encourages businesses to be more responsible in their use of resources, such as selecting raw materials that are more environmentally friendly and designing products that are easier to recycle or that are biodegradable. Paying attention to sustainability improves the chances of business success in the distant future. However, the strive to maximize profits in the present time period and the potentially higher costs of operating in a sustainable way, mean that businesses often do not make efficient use of all available resources. Resistance to change and/or to embrace the ethos of sustainability create further obstacles for economic sustainability.



Figure 59.8 - Recycling is vital for sustainability

Nevertheless, most analysts believe that economic sustainability is vital for any business striving to establish profitability over the long term. It is equally important for non-profit organization as they need to earn a financial surplus to remain operational in the future. This will enable the organization, irrespective of its legal status, to continue operating year after year. From this perspective, economic sustainability becomes part of a firm's corporate strategy in order to help the business to survive, thrive and contribute to the economic wellbeing of individuals and societies via the creation of jobs and wealth.



Figure 59.9 - Should businesses use renewable energy sources, even if it is more costly to do so?

ATL Activity 59.2 (Research skills)

Investigate the extent to which the shift to using electric vehicles (rather than petrol fuelled vehicles) is ecologically sustainable.

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Creativity

"If you hear a voice within you say, 'You cannot paint,' then by all means paint and that voice will be silenced."
- Vincent van Gogh (1853-1890), Dutch post-Impressionist painter

Creativity is the process of generating something original, be it a new idea or considering an existing idea from new perspectives. It includes the ability to recognize the value of new ideas and perspectives when developing responses to the problems of the world. The formation of new ideas and solutions is an essential aspect of creative problem solving in response to changes in the internal and external environments in which businesses operate.

Creativity in the business world can empower organizations and give them competitive advantages. Many of the most economically successful businesses and countries are the ones that thrive on creativity. Creative entrepreneurs are those who come up with and commercialize a new idea or reinvent (redefine and improve) an old idea. In some cases, they even create new industries, such as smartphones, tablet computers and online streaming services. In today's ever-more unpredictable business world, creativity can give organizations a unique or distinctive selling point (see Chapter 27).

Creativity covers several aspects of thinking, such as the higher order skills of problem solving, imagination, originality, ingenuity and visionary. Essentially, there are no limits to what entrepreneurs and businesses can do with creativity. Albert Einstein (879 - 1955), the renowned theoretical physicist who developed the theory of relativity, said "Creativity is intelligence having fun" and "Imagination is more important than knowledge. Knowledge is limited." Interestingly, if you rearrange the letters in "Albert Einstein", you actually get "**Ten Elite Brains**"! How's that for a bit of creativity?

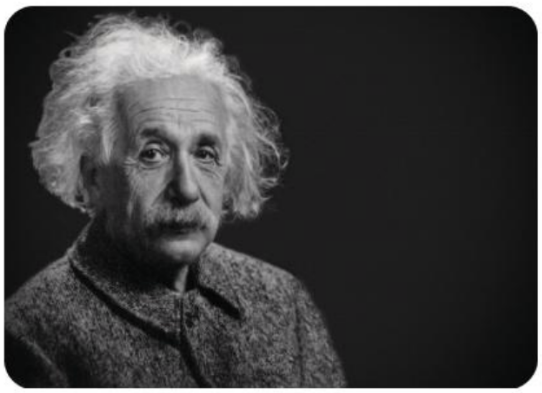

Figure 59.10 - Ten Elite Brains?

Creativity applies to all aspects of business activities and operations. For example, it is integral to any effective marketing strategy as firms need their marketing mix (see Chapters 27 - 33) to appeal to customers. David Ogilvy (1911 - 1999), often referred to as the 'Father of Advertising', said "*If it doesn't sell, it isn't creative.*"

Creativity is also important for operations management, such as the notion of Kaizen or continuous improvements (see Chapter 37). Innovative entrepreneurs create new sources of revenue based on technological developments and other changes in the market, e.g., changing demographics and changing customer demands (needs and wants). Management guru Michael Porter said that creativity and innovation are central issues for the prospects of a business and for the economic prosperity of a country. Hence, this incentivizes entrepreneurs and managers to think and act creatively and more holistically about their entire business.

Theory of Knowledge (TOK)

Is creativity disruptive to corporate culture? Does this matter?

Theory of Knowledge (TOK)

To what extent does the Persian Proverb "*Doubt is the key to knowledge*" apply to the concept of creativity?

Key concept

To what extent do the ten traits of the IB Learner Profile promote creativity?

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Supplementary information

Final thoughts on CBL and Business Management

"If we teach today's students as we taught yesterday's, we rob them of tomorrow."
John Dewey (1859 - 1952), renowned educational reformer

Many teachers will have been using a concept-based learning (CBL) approach since (or even before) the launch of the current Business Management course (first exams 2022). Whilst CBL might seem 'new' to some teachers, it is nothing to be fearful of. CBL in Business Management provides a useful framework using four conceptual lenses that students (and teachers) can use to provide a more holistic and meaningful way to understand and gain knowledge in the subject. Students who embrace such an approach in their studies will naturally recognise the links between CBL and TOK (both are interdisciplinary and intradisciplinary, promoting higher-order critical thinking skills). For instance, consider how business activity impacts on climate change and damage to the natural environment. It should be possible to make such considerations through the four lenses (or framework): change, ethics, sustainability and creativity.

Embracing CBL as an approach to teaching and learning, as well as adopting the key concepts in Business Management, can certainly empower students in their Internal Assessment (they key concepts are a formal requirement of the internal assessment), the Extended Essay, their final IB examinations and, perhaps far more importantly, beyond.

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Theory of Knowledge (TOK)

To some extent, science offers certainty when organizations face continual change, crises and evolution. Based on the various business management tools, concepts and theories you have studied during the course, justify whether you think that management is more of an art or a science.

Supplementary information

Theory of Knowledge (TOK)

Do you think the prescribed key concepts provide the foundations for business education or indoctrination in the study of Business Management?

For teachers, CBL is far from revolutionary but certainly requires teacher input. Consider the following questions that you might be asked during a job interview, a performance management (appraisal) meeting or after a lesson observation:

- What makes a lesson 'successful'?
- How do you engage your students in their learning?
- What makes teaching (and/or learning) meaningful?
- How do you know your students are learning?

Quite simply and frankly, doesn't concept based learning help to address the above questions to a rather large extent?

All the best for embracing and implementing concept-based teaching and learning in your schools!

KEY TERMS

Change can be expressed as a conversion, transformation or movement from one form, state or value to another.

Concepts are large, interdisciplinary ideas that have relevance both within and across academic subject areas. They help to move students from content-based knowledge to deeper understandings by using conceptual lenses that facilitate the transfer of knowledge.

Creativity is the process of generating something original. It includes the ability to recognize the value of new ideas and perspectives when developing responses to problems of the world.

Ethics are the socially accepted moral principles that guide decision-making, based on the society's collective belief of what is right and what is wrong.

Sustainability refers to being able to meet the needs of present generations without compromising or jeopardizing the ability of generations in the future to meet their own needs.

Chapter 60
The Internal Assessment (IA)

"The secret of getting ahead is getting started."
- Mark Twain (1835 - 1910), American author

The Internal Assessment (IA)

The Internal Assessment (IA) is a compulsory component of the Business Management course. The IA is a research project that requires you to apply appropriate business management tools and theories (content) to a real organizational issue or problem (context) using a conceptual lens (concept).

The IA is internally marked by your teacher, but externally moderated by the IB. The IB recommends **20 hours** are spent in total on producing the IA. For SL students, the IA is worth 30% of the overall course and 20% for HL students.



Figure 60.1 - You are expected to spend 20 hours on your IA

For the IA, you are required to:

- Select a real business issue or problem for your research project that relates to any part of the syllabus.
- Refer to a single organization although you can consider industry-wide issues that impact on your chosen organization.
- Use one of the four key concepts (creativity, ethics, sustainability or change) as a conceptual lens to focus your research work. You must be able to demonstrate a deep understanding of your chosen key concept if you are to achieve highly on the internal assessment.
- Provide a research question for your research project. This can be either be forward looking or backward looking. You can, but do not have to, include the chosen concept in your research question.
- Base your research on primary and/or secondary research. These must be selected for their suitability (to the research question) and in sufficient depth and breadth. Note that it is possible to achieve the top mark band with (i) only primary research for the 3 – 5 supporting documents, (ii) only secondary research or (iii) a combination of both primary and secondary research.
- Attach 3 - 5 supporting documents to the research project from which the majority of the information has been obtained for your analysis.
- Produce and submit a written research project that does not exceed 1,800 words.
- Fully reference the 3 - 5 supporting documents as well as additional sources (such as IB textbooks for the Business Management tools and theories used in the analysis). These sources must also be included in a bibliography.

CORE

Supplementary information

The importance of the key concept in the IA

The research project for the IA must make explicit use of only **one** of the four key concepts in the Business Management course (creativity, change, ethics or sustainability). This must be used as a conceptual lens through which to analyse your work.



Figure 60.2 - You must use **one** of the key concepts throughout your IA

Your chosen key concept may, but does not have to, appear in the research question. However, the chosen key concept is required to be stated on the title page of your internal assessment (see Box 60.1).

There are five marks available for the identification and use of a relevant key concept. To achieve the top mark, you must (i) state the key concept chosen for the IA and (ii) apply this effectively *throughout* your research project.

The section below shows five examples of suitable IA research questions for each of the four key concepts.

CORE

Examples of IA research questions

Key concept: Creativity

1. To what extent has Flowers By Cam's innovative use of social media marketing been successful?
2. How should Muller Bookstores differentiate itself from other bookstores in Dusseldorf?
3. How effective has The Studio adjusted its promotional strategy to attract a wider target market in Sai Kung, Hong Kong?
4. What methods of non-financial motivation should Pointwell Ltd. implement to reduce its staff turnover rate?
5. How effective have Xiaomi's growth strategies been in enhancing the company's market position?

Key concept: Ethics

1. How ethical has McDonald's in Oregon, USA, been in competing for employees during the COVID-19 pandemic?
2. To what extent did Uber Eats violate its ethical code of practice by exploiting gig workers in the UK?
3. How can British Airways best resolve the industrial dispute with its cabin crew?
4. How effective is Greenpeace's promotional strategy in Poland?
5. How competitive is the zero-pricing strategy of 'The Standard' (newspaper)?

Key concept: Sustainability

1. How effective have Natural Elements Skincare's internal growth strategy been in strengthening the company's corporate image in the UK?
2. To what extent has Rakuten Seiyu Netsuper's pricing strategies enabled the company to stay competitive in Japan's growing online grocery market?
3. Will OLA's investment in environmentally friendly e-scooters improve its market share in Mumbai, India?
4. To what extent are Volkswagen's electric cars ecologically and economically sustainable?
5. How likely will the product recalls of Nissan cars in New Zealand have a negative impact on the brand?

Key concept: Change

1. Will changing ZARA's distribution strategy improve its profitability?
2. Will Netflix's change in its product portfolio strategy (its gaming platform) be likely to increase the company's profitability?
3. To what extent has the lack of HGV vehicle drivers in the UK affected the supply chain management at Tesco?

4. How will KPMG's decision to abolish homeworking following the removal of COVID-19 restrictions impact its labour productivity?

5. Should Citibank enable its employees to continue working from home despite the recent lifting of COVID-19 restrictions?

Top Tip!

Ensure you have a copy of the assessment criteria for the IA (see subject guide, pages 56 - 58). This set of criteria is used to mark your internal assessment, so you must familiarize yourself with how the rubric marks are awarded.

Top tips for the Internal Assessment

Box 60.1 - The IA title page

The following must appear on your title page (cover sheet) for the internal assessment:

- Subject: Business Management
- Level: Higher or Standard Level
- Research question: This must be phrased as a probing question
- Key concept: Creativity, Ethics, Sustainability or Change
- Word count: this must be equal to or less than 1800 words

All internal assessment must be anonymized. Therefore, it is important that you do not include your:

- Candidate name
- Candidate number
- School name
- School code

Also, please note that all IAs require a **declaration of authenticity** from each candidate. Check with your teacher about the protocol for this and how it is administered at your school.

Assessment

The IA is a compulsory component of the course. You must complete an 1,800-word research project based on a real business problem or issue facing a single business organization. The area of focus must be related to the BM syllabus.

The IA is internally marked by your teacher, but externally moderated by the IB. You are expected to spend 20 hours in total on producing the IA, which has a 30% weighting for SL students and 20% weighting for HL students. So, it is imperative that you devote time to understand the demands of the IA so that you can complete this successfully

Some important points about the IA include:

- The research project requires analysis and evaluation of the issue or problem, i.e., you must form substantiated judgments.
- Your supporting documents can be based on primary **and/or** secondary sources. However, these must be suitable (relevant to the research question) and provide sufficient breadth and depth (do not use supporting documents only from the same source).
- Three to five supporting documents (SDs) must be included. The SDs must be contemporary in nature, i.e., within a maximum of 3 years prior to submission of the IA to the IB. The SDs must form the majority of the information for producing the research project.
- One of the 3 – 5 supporting documents can be a transcript of a video/audio source, such as a television documentary or radio broadcast. This must be from a reliable source and needs to be authentic so that it can be traced (checked).
- All supporting documents and any additional sources must be recorded in a bibliography. This must include all works cited in the research project.

Supplementary information

- You must also include all supporting documents as an appendix. This will need to be uploaded for assessment purposes. These documents should be clearly labelled, e.g., 'Supporting document 1'. This will help with citation and referencing in your research project.

- Avoid using SDs with many pages. The IB recommends that each SD should not exceed five pages (A4 pages). Where appropriate, highlight the part of the SD to show which section(s) you have used in the research project.

- The IB expects you to include in-text citations/references of the SDs. The citation and referencing system must enable the moderator to locate the original sources easily. It is up to the school to decide which referencing system should be used. If students do not reference their work, issues about the authenticity of the work may be raised.

- The word limit is **1,800 words** - moderators are instructed not to read beyond the 1,800th word of the research project. So, make sure you stick to the word count limit for reasons of academic integrity.

- You must provide a declaration of authenticity to confirm that the work is your own original work. This can be done as part of the coversheet of the IA or as a separate declaration that is kept by your teacher/school.



Figure 60.3 - Make sure you stick to the 1,800-word count limit

Common mistake

Students sometimes fail to include (upload) the supporting documents for assessment purposes. It is not acceptable to only include these in the bibliography as moderators will not have the capacity to search for missing documentation. At times, some students include *more* than five supporting documents and this is not acceptable either as it will be challenging for teachers and moderators to apply the stipulated assessment criteria. So, in a nutshell, stick to the guidelines and instructions from the IB.

Examples of supporting documents (which should provide a range of views and ideas) include:

- Academic journals / publications
- Audio-visual file transcript (only one allowed, if used)
- Business plans
- Company annual reports (such as final accounts)
- Company website (extracts)
- Face-to-face and online interviews (if used, a copy of the interview questions and summary of the responses must be included)
- Face-to-face or online surveys/questionnaires (if used, a copy of the questions and a summary of the findings must be included)
- Focus group discussions (if used, a copy of the questions and a summary of the findings must be included)
- Government statistics
- Market research surveys and analyses
- Mission statements
- Newspaper articles (local, national or international press)
- Web-based reports.

Textbooks and class notes can be used as additional sources for the SL IA, but do not count as supporting documents. However, if used, these must also be referenced and recorded in the bibliography.

Business theories and techniques can be found in the Business Management Toolkit*. There is no need or expectation for SL students to use any of the HL only tools for the IA. Additional tools, theories and techniques that might be applicable to the IA (SL or HL) include:

- Break-even analysis
- Cash flow management
- Crisis management

- Investment appraisal
- Management Information Systems
- Marketing planning
- Market research
- Marketing strategies
- Motivation theory
- Outsourcing strategies
- Position (Perception) mapping
- Production planning
- Ratio analysis
- Research & Development
- **Note*: a SWOT or STEEPLE analysis produced by the candidate, if used, does not qualify as a supporting document.

Recommended format for the IA

- Title page, including the research question
- Contents page, with page numbers
- Introduction:
  - o An itantroduction to the organization
  - oThe industry in which it operates
  - o A clear outline of the issue or problem under investigation
  - o Links to specific sections of the syllabus that the IA focuses on, and
  - o The methodology.
- Body:
  - o Findings (based on the supporting documents)
  - o Analysis and discussion of the findings
  - o Integration of the key concept
  - o Evaluation of the findings and discussions.
- Conclusion(s):
  - o Do not include anything new that has not been discussed in the body of the research project
  - o Do acknowledge any aspects of the research question that have not been fully answered (i.e., recognise any unanswered question from the research)
  - o Must answer the specific research question.
- Bibliography
- Appendices (include the 3 to 5 supporting documents).

Top tips from students (HL and SL)

Finally, these are some top tips from some of my own students:

- Do an IA on something you are confident that you can get sufficient information about. *Joshua Chan*
- Try to include quantitative analysis and tools because these help to give clearer conclusions. *Keillian Tai*
- If you use interviews or questionnaires make sure your teacher checks over them because if your questions aren't that good, you won't get meaningful data. *Chris Ting*
- Do your very best on the first draft (complete it) as the written feedback will really help you to get top marks in the final draft. *Aska Mertens*
- Plan your IA well; not only will this allow you to enjoy this unique experience learning about a real-world business, but it will also save a lot of frustration and stress as the deadline approaches. *JK Park*
- Refer to your research question frequently and throughout the process to ensure that you don't stray off topic. *Beverly Nam*
- Remember to save and cite your supporting documents in the bibliography as you work through your IA or else you will forget where all the information comes from, which is very time consuming to find it all later. *Jacklyn Kwok*

- After writing your draft, check against the assessment criteria that you have written only what is necessary and get rid of anything else - it will only take up your word count! *Shelly Yuen.*

- Only the information you put in the main part of the IA counts towards the overall assessment, so don't put any analysis in the appendices as moderators won't read or credit you for this. *Nicollette Scrouther*

- Avoid vague or broad research questions, as this causes a lack of focus, which negatively impacts on your final grade. *Lucas Rothwell*

- It's really hard to do a proper STEEPLE or SWOT analysis within the word count limit, so it's best to avoid these as I found out the hard way. Evidence and referencing are required, so that's really difficult given the word limit. *Sayeeda Urbana*

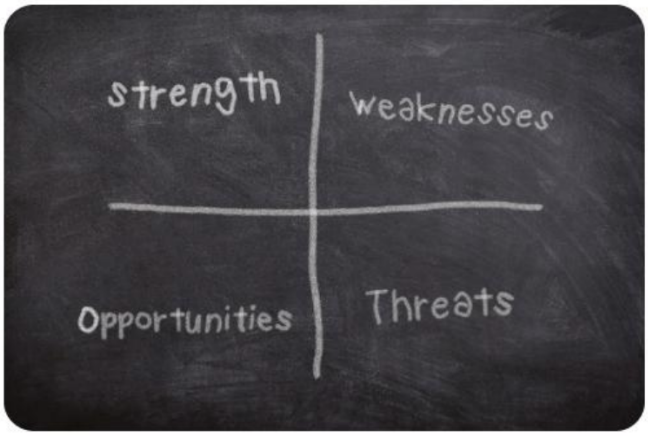

Figure 60.4 - If you choose to use SWOT analysis for the IA, do consider whether it adds any real value to the research

- When you write your conclusion(s), you must address the research question - it is so easy to lose focus and answer a different question instead. *Maleah Do Cao*

- Make sure each of the supporting documents chosen are clearly relevant to addressing your research question. *Jakey Solomon*

Remember to provide **evidence** from your supporting documents to substantiate all your points. In all cases, it is vital to collect and present meaningful evidence in your research project. Watch this short but very funny video clip, featuring comedian Joe Lycett's parking ticket story to see why providing evidence is so important: https://goo.gl/M45cYG.

My final tip is to conscientiously **make the time to work on your IA**. This component of the Business Management course is worth a significant amount of your final exam (it's equivalent to two grade boundaries for HL students and three grade boundaries for SL students). So, by putting in the effort with the guidance of your teachers, you are essentially working on your final examination score. As German writer Johann Wolfgang von Goethe (1749 - 1832) said, "*What is not started today is never finished tomorrow*."

All the best with the IA!

Chapter 61
External Assessments

"Proper preparation prevents poor performance"
- The 5Ps of effective exam preparation

Command words

It is crucial that command words are read properly in the examinations. Each command word in a question indicates to you the level of depth of answers required (see below for details). Hence, if asked to **calculate** the break-even point for a business, there is no need to **define** or to **explain** break-even. Note the syllabus uses Assessment Objectives (AO) to categorise the different command terms.



Figure 61.1 - Understanding command terms is vital to exam success

Figure 61.1 - The command terms used in IB Business Management

Define	AO1	**Assessment Objective 1** Demonstrate knowledge and understanding	These command terms require you to learn and comprehend the meaning of information.
Describe	AO1		
Identify	AO1		
List	AO1		
Outline	AO1		
State	AO1		

Analyse	AO2	**Assessment Objective 2** Demonstrate application and analysis of knowledge and understanding	These command terms require you to use your knowledge and skills to break down ideas into simpler parts and to see how the parts relate
Apply	AO2		
Comment	AO2		
Demonstrate	AO2		
Distinguish	AO2		
Explain	AO2		
Suggest	AO2		

Compare	AO3	**Assessment Objective 3** Demonstrate synthesis and evaluation	These command terms require you to rearrange component ideas into a new whole and make judgments based on evidence or a set of criteria
Compare and contrast	AO3		
Contrast	AO3		
Discuss	AO3		
Evaluate	AO3		
Examine	AO3		
Justify	AO3		
Recommend	AO3		
To what extent	AO3		

Annotate	AO4	**Assessment Objective 4** Use and application of appropriate skills	These command terms require you to demonstrate the selection and use of subject-specific skills and techniques.
Calculate	AO4		
Complete	AO4		
Construct	AO4		
Determine	AO4		
Draw	AO4		
Label	AO4		
Plot	AO4		
Prepare	AO4		

Consult the syllabus guide (pages 67 - 68) for an explanation and example of each of these command words.

Exam tip !

Each and every exam question will contain a command word, so make sure you know what the command term means and the skills level it corresponds to.

Exam tip !

For the vast majority of exam questions, do not write your answers in bullet point format. This approach tends to encourage students to give vague, unexplained and unsubstantiated responses. This is particularly the case for questions with AO2 and AO3 command terms.

Overview of the external assessments

The table below provides an overview of the different assessment components along with the timings and weightings for both SL and HL.

Table 61.2 - Overview of IB assessment for Business Management

Assessment Component	Standard Level		Higher Level	
	Time	Weight	Time	Weight
Paper 1 Based on a pre-released statement that specifies the context and background for the unseen case study	1 hour and 30 minutes	35%	1 hour and 30 minutes	25%
Paper 2 Based on unseen stimulus material with a quantitative focus	1 hour and 30 minutes	35%	1 hour and 45 minutes	30%
Paper 3 Based on unseen stimulus material with a social entrepreneurship focus	-	-	1 hour and 15 minutes	25%
External assessment	3 hours	70%	4 hours and 30 mins	80%
Internal assessment Business research project	1,800 words	30%	1,800 words	20%

Annotate	AO4	**Assessment Objective 4** Use and application of appropriate skills	These command terms require you to demonstrate the selection and use of subject-specific skills and techniques.
Calculate	AO4		
Complete	AO4		
Construct	AO4		
Determine	AO4		
Draw	AO4		
Label	AO4		
Plot	AO4		
Prepare	AO4		

Consult the syllabus guide (pages 67 - 68) for an explanation and example of each of these command words.

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Paper 3 Based on unseen stimulus material with a social entrepreneurship focus	-	-	1 hour and 15 minutes	25%
External assessment	3 hours	70%	4 hours and 30 mins	80%
Internal assessment Business research project	1,800 words	30%	1,800 words	20%

Paper 1

The Paper 1 exam is based on a pre-released statement that specifies the context and background for an unseen case study. Paper 1 is the same for SL and HL students (i.e., there are no HL extension topics examined in this paper).

The length of the examination paper is 1 hour and 30 minutes for both SL and HL.

Around **3 months** prior to the external exam, the IB will release a statement with two parts:

1. A small number of topics that provide context to the Paper 1 case study. These topics will *not* be topics that are in the guide but ones that students are asked to research for approximately **5 hours**. These topics do, however, build on topics contained in the syllabus. *The aim is to assess students' knowledge around important contemporary topics in Business Management that could not have been anticipated when the guide was first written.*

2. The first 200 words or so of the case study itself. The release of this portion of the case study will provide you with some additional context and will reduce the number of words to be read during the examination period. The final examination will contain a case study, of approximately 800 to 1,200 words, that you do not see before the examination. Most questions will be **qualitative,** although some minor calculations could be part of the Paper 1 assessment.

There are two sections in Paper 1:

- Section A - You must answer all structured questions in this section based on the case study. The maximum score is 20 marks. All 5 units of the syllabus can be assessed, except for the HL only topics.

- Section B - Students answer one out of two extended response questions based on the case study. The maximum score is 10 marks. Again, all 5 units of the syllabus can be assessed, excluding the HL only topics.

Hence, the total number of marks for Paper 1 (SL and HL) = 30 marks.

The overall weighting of Paper 1 for SL is 35% and 25% for HL.

Top Tip!

Well-structured essays require:

- An introduction
- A body
- A conclusion
- Fit-for-purpose paragraphs

Use the PEELS structure when writing your extended response (essay) answers. Each paragraph should contain:

- A single point (the idea or argument being presented)
- An explanation of your point
- Examples to help clarify your argument
- A link back to the essay question
- Consider different stakeholder perspectives to show evidence of critical thinking.



CORE

Supplementary information

Paper 2

The Paper 2 exam is based on unseen stimulus material within the exam paper with a **quantitative** focus. Questions for SL and HL students are different, but the format and intent are similar.

The length of the examination paper is 1 hour and 30 minutes for SL and 1 hour and 45 minutes for HL. The overall weighting of Paper 2 for SL is 35% and 30% for HL.

Most questions will be quantitative, but some qualitative will be included. Unlike with previous Paper 2 exams, the stimulus material will be presented in parts. Each part has a question, so students need to read each part and answer the question in sequence. The stimulus material will be a combination of written and diagrammatic stimulus, such as charts and infographics.

For SL students only, one of the stimulus options in Section B of Paper 2 may be on a social enterprise. HL students will be assessed on a social enterprise separately in the Paper 3 exam.

There are two sections in Paper 2 for SL students:

- Section A - You must answer all structured questions in this section based on the unseen stimulus material (20 marks). All 5 units of the SL syllabus can be assessed.
- Section B - You need to answer one out of two questions comprised of some structured questions and an extended response question based on the unseen stimulus material. (20 marks).

Hence, the total number of marks for Paper 2 (SL) = 40 marks.

There are also two sections in Paper 2 for HL students:

- Section A - You need to answer all structured questions in this section based on the unseen stimulus material (30 marks). All 5 units of the syllabus can be assessed, including HL only topics.
- Section B - You must answer one out of two questions comprised of some structured questions and an extended response question based on the unseen stimulus material, which includes HL only topics (20 marks).

Hence, the total number of marks for Paper 2 (HL) = 50 marks.

Paper 3

The Paper 3 is for HL students only. It is based on unseen stimulus material about a **social enterprise**. The stimulus material will consist of a short introduction to a social enterprise, supported by a visual representation of a product and 5 or 6 excerpts from various documents (such as emails, Twitter feeds, newspaper articles and so forth). Note that the stimulus material can be a for-profit or non-profit social enterprise.

The Paper 3 examination requires you to:

- Identify and describe a human need.
- Identify and describe the potential organizational challenges facing the social entrepreneur wanting to meet this need.
- Write a decision-making response that includes a plan of action (justified recommendations).

HL students answer the one compulsory question based on the unseen stimulus material (25 marks). All 5 units of the syllabus can be assessed, including HL extension topics. Hence, the total number of marks for Paper 3 (HL only) is **25 marks**.

The duration of the exam is 1 hour and 15 minutes. The overall weighting of Paper 3 is 25%.

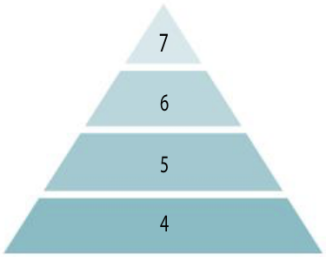
Top tips for improving evaluation in Business Management

"Do not go where the path may lead; go instead where there is no path and leave a trail."
- Ralph Waldo Emerson (1803 - 1882), American philosopher

The Hierarchy of Skills

Examination scripts are marked against a set of assessment criteria. These in turn test the student's demonstration of different skills, from knowledge of information (which crudely equates to a Level 4) and evaluation (Level 7).

- Evaluation
- Examination
- Application
- Information (Knowledge)



What is examination?

- 'Examine' means an assessment of a business management issue or problem.
- It requires the weighing up of the relative importance of different arguments.
- 'Examine' as a command term requires a balanced, two-sided argument.
- It often benefits from the use of current real-world examples to add substance to your answers.

What is evaluation?

- Evaluation compares different views about a business management issue or problem.
- It requires views and arguments to be fully substantiated, supported by examples and evidence where possible.
- Evaluation requires a reasoned (justified) conclusion.
- Judgement is made about which argument holds most significance.
- It requires evidence of critical thinking (think TOK!)

Evaluation and Theory of Knowledge (TOK)

The skill of evaluation is embedded in the TOK course. Evaluation is as much about asking questions as it is about answering them. For example, students might question whether the following about Business Management theories, tools and techniques:

- Are they overly simplistic or even overly complicated in some cases?
- Are they culturally biased?
- Do they apply to different organizations across the globe?
- Are they applicable (realistic) in the real and highly complex business world?

Evaluation and the integrated nature of Business Management

Remember that Business Management is an integrated discipline and therefore any single event may have direct or indirect impacts on other aspects of a business. For example, a hostile takeover (Unit 1.5) is likely to affect:

- Organizational structure (Unit 2.2)
- Leadership and management (Unit 2.3)
- Levels of staff motivation (Unit 2.4)
- Organizational and corporate culture (Unit 2.5)
- Cash flow (Unit 3.7)
- Budgets (Unit 3.9)
- The role of operations management (Unit 5.1)
- Crisis management and contingency planning (Unit 5.7).

Useful evaluation phrases

The suggested phrases below might help you to focus your answers and to incorporate critical thinking to show that you are evaluating Business Management concepts, tools, theories and techniques. Remember that the best answers are written in context of the case study, with application of real-world examples where appropriate.

- By contrast …
- Conversely …
- Hence, this might not be practical because …
- However, ...
- In conclusion ...
- In reality …
- In the short term … but in the long term ...
- It depends on whether ...
- Managers might question the feasibility of this option because…
- Nevertheless …
- On the other hand …
- Other factors should be considered by the organization, such as ... because …
- Other stakeholders of the organization might …
- Overall, ...
- The most significant of these factors to the organization is ... because …
- The outcome depends on several factors such as …
- The text suggests that … although …
- This could cause conflict in the organization because …
- This is likely to cause ... because …
- Time lags should be considered because…

Evaluation frameworks

It is useful to have a framework when writing your extended response answers. This applies to your Internal Assessment as well as the final exams (external assessment). Here are the top five favourite frameworks that you might find useful.

1. The DEAD and DEADER framework

Brett Hillman and **Fiona Charnley** passed on this great top tip during an IB Workshop that I was running in Hong Kong: the DEAD and DEADER framework. In order to gain a Level 6, you should include:

- **D**efinition(s)
- **E**xplanations / examples
- **A**dvantages
- **D**isadvantages

In order to gain a Level 7, you need to demonstrate two more skills:

- **D**efinition(s)
- **E**xplanations / examples
- **A**dvantages
- **D**isadvantages
- **E**valuation
- **R**ecommendation(s)



I particularly like the DEADER acronym as 'Recommendations' reminds us that Business Management is ultimately about two things: **problem-solving** and **decision-making** in business organizations.

2. The DATE SLAP framework

My students really like this one – go on a "DATE" with an examiner to score high marks!

- **D**efinitions
- **A**pplication
- **T**heory
- **E**valuation

At the end of the date, you don't want to see the examiner again, so make a judgement call – add a 'SLAP' to conclude the end of your date:

- **S**takeholder perspectives
- **L**ong term versus short term impacts
- **A**ssumptions made in the arguments
- **P**rioritise your arguments



Students are often confused about how best to evaluate, so use any combination of the above "SLAP" methods to help.

Of course, your DATE doesn't have to end with a SLAP, as you may choose to just be PALS.

3. The LOSERS© framework

My personal (and favourite) acronym is the **LOSERS©** framework. In evaluating the strategic options and decisions of businesses, it is important that they avoid being 'LOSERS' by careful consideration of the:

- **L**ong term - Does strategic decision-making improve the firm's future direction and competitive advantages.
- **O**bjectives - Are the strategic decisions in line with the organization's corporate objectives?
- **S**takeholders - Who are the key stakeholders? Which ones are most affected by the decision?
- **E**xternal environment - What are the restraining and driving forces that are beyond the firm's control?
- **R**esources - Does the business have the financial and human resources to implement the plans (recommendations)?
- **S**ynergies - Overall, does the decision or strategy add value (synergy) to the organization?

4. LOST SMS to add

This top tip comes from our esteemed IBEN colleague Dr. **Rima Puri** who uses the LOST SMS framework with her students to develop skills of evaluation:

- **L**ong run - What are the impacts of the decision in the long run?
- **O**bjectives - What is the purpose of the decision and how is it relevant to the business organization?
- **S**hort run - What are the impacts of the decision in the short run?
- **T**ime bound - What is more important in the short run and how might this differ in the long run?
- **S**takeholders - What are the impacts of the decision on key stakeholders (individuals and group stakeholders) of the organization?
- **M**easurable - What are the financial or quantitative implications of the decision?
- **S**pecific - Have you applied specific information/data from the stimulus material throughout your extended response answers?

5. The SPOTT framework

This top tip was shared by **Fanie van der Merwe**, Head of Humanities at Dulwich College Suzhou, during a workshop in April 2021. Mr. van der Merwe commented that his students often struggle to apply their answers to the context of the organization in the case study, i.e., they do not always *spot* the important stimulus material that should be used in their answers. So, here is Mr. van der Merwe's excellent idea to help them - he calls it 'SPOTT analysis'.

- S – Stakeholder perspectives
- P – Product details
- O – Objectives of the organization
- T – Type of business entity
- T – Target market(s)

Top 5 exam preparation tips

"Continuous effort - not strength or intelligence - is the key to unlocking our potential."
- Sir Winston Churchill (1874-1965), UK Prime Minister 1940-1945 and 1951-1955



Tip #1 - Learn the command words

It is crucial that command words are read properly in the examinations. Each command word (see Table 61.1 above) in a question indicates to you the depth of response that is required by the IB. Hence, if asked to *calculate* the break-even point for a business, for example, there is no need to *define* or to *explain* break-even.

Do you know what is required of these command terms? If not, find out or ask your teacher! You can refer to the Business Management guide for an explanation and example of each of these command words (pages 67 - 68).

- Analyze
- Complete
- Explain
- Identify
- Outline
- Annotate
- Construct
- Examine
- Justify
- Recommend

Tip #2 - Learn the structure of each of the exam papers

There are two externally assessed papers for the SL exams and three papers for HL. You should refer back to Table 61.2 above for the details. All of these have a different focus as well as differences in what is assessed. For example, Paper 1 is mainly qualitative whilst Paper 2 is mainly quantitative and Paper 3 (HL only) focuses on a social enterprise. A commonality for the three papers is that all five units of the syllabus can be assessed.

Tip #3 - Plan your revision carefully

Trying to learn the whole Business Management syllabus without a proper plan is not going to work. A more effective technique is to revise sections of the syllabus in manageable sessions, following a well-structured revision timetable. For example, you might want to revise Finance and Accounts in a particular revision session, perhaps focusing on one or two aspects, such as cash flow forecasting (Unit 3.7) or sources of finance (Unit 3.2).

It is also vital to build in revision time to learn your quantitative methods (especially for Paper 2). There are plenty of formulae to learn, especially as there are some calculations not included in the formulae sheet in the actual exams.

Whatever you do, don't leave everything until the last minute - you simply cannot revise the entire BM curriculum in a few nights. Without a plan, you won't know where you're going and how you're going to get there. This means valuable revision time is likely to be wasted. Remember the famous saying that failing to plan is planning to fail. Below is a list of some of the things you could try as part of your revision plan:

- Use the BM syllabus (pages 23 - 36) as a starting point when planning your revision.
- Draw up a revision plan for each week - and stick to it! Some flexibility might be necessary but remain focused and disciplined. You could use a Gantt chart for this purpose if it helps.
- Take careful note of the Assessment Objectives in the syllabus as examiners use these when setting exam questions!
- Allocate more time to the topics that you find most challenging.
- Assign some time for sufficient rest breaks and recreation; a refreshed mind is a more productive one.
- Don't procrastinate - turn off your smartphone, games consoles and social media notifications (personally, I think Twitter, Instagram, WhatsApp and YouTube are great, but they might just be the world's best procrastination tools!)

Tip #4 - Learn the quantitative methods

The BM syllabus incorporates many quantitative techniques (HL topics shown in italics and units of the syllabus shown in brackets), such as:

- Balance Sheets (3.4)
- Break-even analysis (5.5)
- *Budgeting (3.9)*
- Cash flow forecasting (3.7)
- *Contribution analysis (BMT)*
- *Cost to make vs Cost to buy (BMT)*
- Costs and revenue (3.2)
- *Critical path analysis (BMT)*
- *Decision trees (BMT)*
- *Depreciation (3.4)*
- *Descriptive statistics (BMT)*
- *Gantt charts (BMT)*
- Investment appraisal (3.8)
- Market share (4.1)
- *Price elasticity of demand (4.5)*
- Profit and Loss accounts (3.4)
- Ratio analysis (3.5 and 3.6)
- *Simple regression analysis (BMT)*

It is important to learn these quantitative techniques and to be able to use them to aid decision-making. For example, make sure you know the formula for the following:

- Average cost
- Break-even point
- Capital employed
- Closing balance
- Cost of goods sold
- *Cost to buy*
- *Cost to make*
- Gross profit
- Labour turnover
- *Lead time*
- Market share

- Net assets
- Net cash flow
- Net profit
- Payback period
- *Re-order quantity*
- Safety margin
- *Straight line depreciation*
- Total costs
- Target profit
- Unit contribution
- *Variance*

Again, make sure you learn the definitions and the formulae for the above. Note that the terms in italics above apply to HL students.

CORE

Tip #5 – Practise, practise, practise

Ask your teacher for some past sample or past exam papers and have a go at answering these questions under timed conditions - especially the quantitative questions. There's nothing quite like applying your knowledge of Business Management to a case study about motivation or leadership to really reinforce your understanding. Refer to the official IB mark schemes to gain a better understanding of how marks can be awarded for both the quantitative and qualitative questions in the exam papers. The more practice you get, the more prepared you will be for the final examinations.



Final message from the author

Dear students,

I hope that you find this fifth edition textbook to be of interest and of use in preparing you for learning the Business Management course. I hope you enjoy reading the book as much as I have writing it. Two final pieces of advice come from a couple of my favourite proverbs:

On time management and organization:

"Tomorrow is often the busiest day of the week." Spanish proverb.

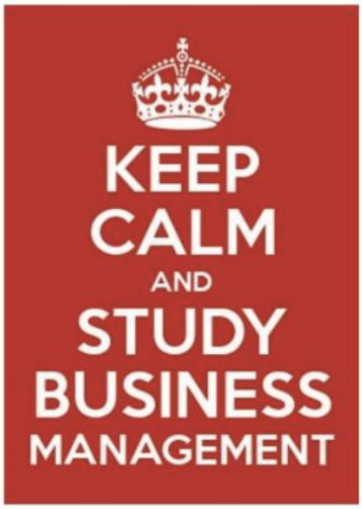
On evaluation:

"One-third of what you see is in front of your eyes, the other two-thirds are behind your eyes."
Chinese proverb

Best wishes for your studies and examinations!

Paul Hoang

Email: paulhoang88@gmail.com
Twitter: @paulhoang88 #IBBusinessManagement



Chapter 62
Extended Essay

"When something can be read without effort, great effort has gone into its writing"
- Enrique Jardiel Poncela (1901-1952), Spanish playwright and novelist

The Extended Essay (EE)

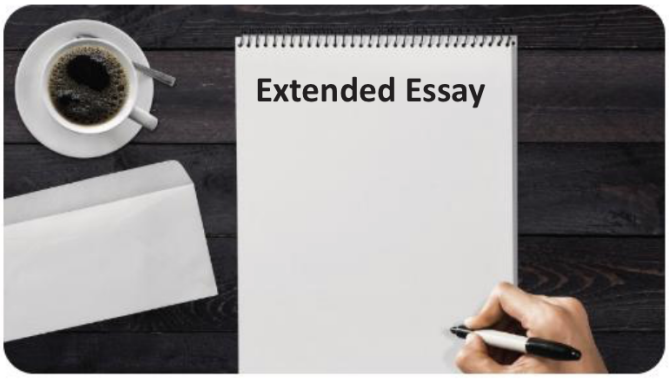


Figure 62.1 - The EE is compulsory for all DP students

The Extended Essay (EE) provides you with the opportunity to complete an extensive piece of academically rigorous research. The EE is compulsory for all IB Diploma students and should be based on an area of personal interest to you. Students who fail to submit an EE are not awarded the IB Diploma.*

The guidelines (first exams 2018) suggest that you need to spend approximately 40 hours on the EE, writing up to 4,000 words. It is also suggested you spend 3 to 5 hours with your EE supervisor, including time needed for the three compulsory reflections sessions. The process ends with the third and final reflection session, the viva voce (an oral interview following final submission of the EE). The essay is externally marked out of 34 points by an examiner.

***Note:** An 'E' grade in the Extended Essay or TOK constitutes a 'failing condition'. So, it is vital that you put in the necessary effort and get the support you need from your supervisor to succeed in the EE.

Aims of the Extended Essay

The aims of the EE are to provide you with the opportunity to:

- engage in independent research with intellectual initiative and rigour
- develop research, thinking, self-management and communication skills
- reflect on what has been learned throughout the research and writing process.

Responsibilities of the EE supervisor

- Read and comment on the first and only draft (version) of the completed EE. Supervisors must not edit any of the draft EE.
- Monitor the progress of each student to ensure that the EE is the student's own work.
- Offer guidance to the student in accordance to the guidelines specified in the EE Guide.
- Read the final draft (version) of the EE to confirm its authenticity.
- Conduct three reflection sessions with the candidate: one early on in the process, an interim meeting and then the final *viva voce*. Other sessions/meetings are allowed but do not need to be recorded on the RPPF sheet.
- Complete the EE supervisor's comments on the Reflections on Planning and Progress Form (RPPF). Students must complete 3 written reflections of no more than 500 words in total on the RPPF document.

CORE

Supplementary information

- Submit a predicted grade for the EE based on the assessment criteria.

Exam tip !

The RPPF (worth a total of 6 marks) has a word count limit of 500 words. It is suggested that you write up to 150 words for each of the first two reflections and write up to 200 words for your third and final reflection.

Overview of the Business Management Extended Essay

- The BM EE must be based on conventional (accepted) Business Management theory - you are therefore advised to stick to the topics within the BM syllabus. Note that since 2018, students have been able to use (appropriate) tools, theories and techniques that are not included in the syllabus for the EE, such as Michael Porter's *five forces analysis* or *Blue Ocean Strategy*.
- The EE requires application of BM theory, tools and techniques. Hence, there are plenty of opportunities to apply relevant parts of the Business Management Toolkit.
- Research questions can be backwards looking but must enable you to be evaluative in your work. Do not simply describe historical events.
- You must avoid hypothetical questions, based on possible future events.
- As with all essays, your responses should be written in a coherent and structured way.
- The EE should include breadth and depth of analysis and embrace extensive and detailed academic research.
- The emphasis of BM EEs from 2018 has been on the use of **secondary** data. Students can use primary research if this adds value to the research and addresses the research question.
- A wide range of sources should be used, including: BM textbooks, general business management texts, industry analyses and company annual reports. Undue dependence on a particular source is unlikely to mean that you will be able to write a balanced essay that shows critical thinking.
- Adding conceptual perspectives (the key concepts of change, ethics, sustainability and creativity) can add interest and depth to the EE, such as the ethical and sustainable impacts of business decisions.
- The essay is marked using the assessment criteria in the EE Guide (see https://goo.gl/2pGFLH). Make sure you get a copy of this and become familiar with the expectations for each assessment criterion.
- Examiners will not read beyond the 4,000th word of the essay (excluding the bibliography and appendices). This clearly means that marks will be lost if a student exceeds the word count limit.

Note: the 4,000-word count limit does not include the: acknowledgements, contents page, maps, charts, diagrams, annotated illustrations, tables, equations, formulae and calculations, citations/references, footnotes or end notes, the bibliography and appendices. Also, the RPPF is not part of the 4,000 word limit. © IBO, 2018



Figure 62.2 - Do not exceed the word count limit

Exam tip !

Ensure that all components of your essay are unmistakably related to the actual research question. This will help you to maintain focus and not drift off topic.

CORE

Supplementary information

Formulating an Extended Essay research question (RQ)

- The essay must have a RQ phrased as a probing question, i.e., one that demands inquiry and is worthy of academic study.
- Make sure the RQ has a clear focus that allows the application of relevant theory, tools and techniques. This is often supported by statistical data to assist analysis, discussion and evaluation.
- The RQ should also allow you to engage in a range of detailed research, requiring the selection and use of a range of different sources.

Examples of suitable EE research questions include:

1. How significant is market positioning in establishing Audi as a premium brand in Hong Kong?
2. How effective has the joint venture between 7-Eleven and Ocean Park been as a growth strategy?
3. How effective have the campaigns of Ronald McDonald House Charities been in raising awareness of McDonald's corporate social responsibility in Bromley, UK?
4. To what extent has the joint venture between Nestlé and Häagen-Dazs increased its market share in the ice cream industry in Denver, Colorado?
5. To what extent is cost-plus pricing suitable for Savita Solar?
6. To what extent is sustainability worth committing to for Cathay Pacific Airways?
7. How effective has the takeover of Cadbury's been as a growth strategy for Kraft Foods in Chicago, USA?
8. To what extent has Lego's corporate culture contributed to its financial success?
9. To what extent has New Balance's branding strategy given the company a competitive advantage in the North American sportswear industry?
10. To what extent will the acquisition of Footasylum by JD Sports be successful as an external growth strategy?

Exam tip !

You are required to have both a **topic** and **research question** (RQ) for the essay. For example:

- Topic: An evaluation of financial motivation at Purplebricks Estate Agents.
- RQ: To what extent has the introduction of differentiated piece rate improved labour productivity at Purplebricks Estate Agents?
- Topic: An evaluation of the role of corporate social responsibility practices.
- RQ: To what extent can VW strengthen its corporate social responsibility (CSR) practices following the aftermath of its diesel emissions scandal?
- Topic: An investigation into the success of joint ventures of motor manufacturers.
- RQ: To what extent has the joint venture between Brilliance Auto and BMW been a success as an external growth strategy?

Common mistake

Each year, numerous students adapt their research question for the internal assessment (IA) and use this for the extended essay. This approach must be avoided for two main reasons:

- It may raise issues about academic malpractice as you cannot use work from the IA for the EE. Speak to your supervisor about the rules against 'double dipping' if you need clarification.
- The requirements of the IA are different to that of the EE. For example, you must use secondary research in the essay, but it is acceptable for students to use only primary research for the internal assessment.

Format of the Extended Essay

- Title page - include the essay title, research question, your personal code (not candidate number), the date of submission and the word count.
- Contents page - include all sub-sections of the essay, plus page numbers.
- Introduction - this section includes a brief background to the organization and an outline of the methodology used to provide context to the essay.
- Body - this section includes the findings (results) and analysis of the academic research. Good essays show evidence of critical thinking throughout.
- Conclusion - this should stem from the research carried out, with the conclusion backed with evidence presented in the body of the essay.
- References and bibliography - a comprehensive list that references all sources used. Note that the omission of a bibliography is deemed to be unacceptable for academic integrity purposes.
- Appendices - supplementary evidence and supporting documentation (such as excerpts of company annual reports and newspaper articles) should be placed in this section.



Figure 62.3 - Citation and referencing are required in the extended essay

Exam tip !

Your essay must be anonymized. Therefore, do not include your candidate name, candidate number, school name, centre number or your supervisor's name.

Analytical tools, techniques and theories

It is vital to incorporate the use of analytical tools in the EE - after all, this is a BM essay. Examples of tools, techniques and theories that can aid analysis in the EE beyond those in the BMT include:

- *Budgets (Unit 3.9)*
- Cash flow forecasting (Unit 3.7)
- Cost-based pricing strategies (Unit 4.5)
- *Dynamic pricing (Unit 4.5)*
- Final accounts (Unit 3.4)
- Motivation theory (Unit 2.4)
- Investment appraisal (Unit 3.8)
- Perception maps (Unit 4.2)
- *Price elasticity of demand (Unit 4.5)*
- Ratio analysis (Units 3.5 and 3.6)

Note: analytical tools, concepts and theories in italics are HL only.

Also note that you can also use (appropriate) analytical tools that are not included in the syllabus, such as Michael Porter's *five forces analysis*.

The assessment criteria

The EE is marked out of **34 marks**. All extended essays are marked according to the following set of assessment criteria:

- Criterion A: Focus and method 6 marks
- Criterion B: Knowledge and understanding 6 marks
- Criterion C: Critical thinking 12 marks
- Criterion D: Presentation 4 marks
- Criterion E: Engagement 6 marks

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Note that critical thinking accounts for around 35% of the assessment criteria. Hence, a critical approach to the EE, in which you display the skills of analysis and evaluation, is absolutely essential.

Citation and referencing

Although there are no points explicitly for citation and referencing (C&R), it is expected as part of the IB's guidelines on academic integrity. Moreover, C&R forms part of Criterion D (formal presentation), worth 4 marks. Omitting C&R from your essay may be viewed as academic malpractice, so can result in a failing condition. Ultimately, it is your responsibility to ensure that the EE is authentic, so the works or ideas of others must be acknowledged fully and accurately. You should use a recognized system of academic citation and referencing, such as the Modern Languages Association (MLA) system.

Feedback from the EE Subject Report

The regular EE Subject Reports for Business Management feature some useful tips for both teachers and students, including the need to:

- Spend adequate time to formulate a probing research question that is worthy of academic research, plus a suitable framework for the essay.
- Read past essays to gain a better understanding of the requirements of the EE.
- Read and interpret the assessment criteria - ask your supervisor for clarification if any of the points do not make sense to you.
- Refer to the assessment criteria throughout the EE process.
- Get help directly from your school's EE Coordinator as well as the school librarian for resources and/or suggestions to develop research and referencing skills.
- Maintain a good working relationship and open communications with your EE supervisor.

Exam tip !

You should try to 'mark' a past Extended Essay (ask your supervisor to get a suitable essay for this purpose) using the assessment criteria. The marks can then be discussed with your supervisor. This should help you to gain a better understanding of the assessment criteria before you write your own essay.

Academic integrity

- Academic dishonesty can be defined as any act that enables a student to gain an unfair advantage in an assessed piece of work.
- Examples of academic dishonesty include plagiarism, collusion, duplication of work, deliberately missing an assessment deadline or the fabrication of research data.
- It is your responsibility as an IB student to ensure that the EE is your own work. The use of ideas or the works of others must be fully acknowledged.
- The IB recommends that you adopt an academic referencing system, such as the Modern Languages Association system (www.mla.org).

Modern Language Association MLA

- Schools might choose to use computer software such as www.turnitin.com to detect plagiarism.

CORE

Supplementary information

- To help with authenticating the essay, the three formal reflection sessions are compulsory for all EEs.

Note: The IB uses text matching software to check for possible academic malpractice.

Final top tips for writing a good extended essay

- Choose a topic that you are interested in, because the best essays usually stem from a student's genuine interest in a particular topic or area of the syllabus.
- Ensure your essay is realistically achievable - can you access a range of appropriate sources, that show different views and perspectives of the topic in order to write an essay that is balanced and well substantiated?
- Get the research question right - this is absolutely vital to ensure you meet all the assessment criteria and avoid writing a descriptive essay.
- Maintain a good relationship with your supervisor, who can guide you throughout the entire process, including the planning, reflection and writing process of your essay. This will also enable your supervisor to authenticate your work.
- The essay should be written in an objective way (leave out subjective comments and personal preconceptions).
- Focus on the use of secondary data sources for the essay. Primary data can be used if appropriate, but this must supplement the secondary research that is conducted and add value to addressing the research question.
- The EE is a written (typed) piece of work. Hence, do not include digital and multimedia resources as part of the essay. Instead, cite and reference these resources appropriately.
- The analysis and conclusions should only be derived from the data and evidence presented in the essay.
- Do not introduce anything new in the conclusion, except for any unanswered or new questions that may have arisen from your research.
- Make sure there is evidence of critical thinking throughout the essay. Your EE supervisor can provide some guidance to support you.
- Above all, ensure that the essay fulfills the assessment criteria and that you answer the question explicitly.



Figure 62.4 - Evidence of critical thinking is vital for a good EE

All the best to all those undertaking an Extended Essay in Business Management!

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