INTRODUCTION TO BUSINESS

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Introduction to Business

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SECTION OVERVIEW

About this Text

This Introduction to Business course develops students' understanding of business fundamentals with learning design structured around timely, real-world case studies and examples. Key topics include the role of business, the global economic and legal environment, ethics, marketing, accounting and finance, and managing processes and operations. Enriched OER content (text, video, simulations, etc.) orients students to the shifting business landscape and prepares them for success in business program curriculum and the workplace.

This course was written by Linda Williams (Tidewater Community College) and Lumen Learning, with contributions from Nina Burokas (Mendocino College, Saddleback College) and Robert Danielson (Saint Mary's College of California), and is supplemented by content from OpenStax Principles of Economics, Boundless Business, and videos from multiple sources.

Additional contributions were created by Tina Lance at Germanna Community College, Wendy Wright at Cerritos College, Betty Fitte at Tidewater Community College, Bob Carroll & Andrea Foster at Montgomery Community College, and Charlene Barker at Spokane Falls Community College.

Course Improvements

This new edition of Waymaker Introduction to Business includes improvements and enhancements. We have fully revised Module 8: Entrepreneurship and added a new module, Module 17: Using Technology to Manage Business Information. These improved and new modules both include practice opportunities for students to enrich their learning.

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CHAPTER OVERVIEW

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1.1: Why It Matters- Role of Buisness

Why discuss the role of business in society?

Are you up for a challenge as you start this course?

As you embark on your study of business, you may be thinking that so much of what you will learn in school isn't applicable to your career or future—you aren't *really* going into business, for instance. Here's a challenge that may change your mind.

Stop what you are doing and take a minute to look around you. What do you see? Perhaps you see your living room, where you're sitting at your desk doing your homework. You might be at a local coffee shop, hanging out with some friends who are going to help you study. Or maybe you're sitting on the beach, reading this on your tablet or phone while you listen to the sounds of the ocean and children playing in the sand.

Now, look around again but this time consider everything within your view and ask yourself what all of these things have in common? If you said that they are *all* the product of business, then you're right! How can that be, you ask? Business is everywhere, in everything we touch, we eat, we see, we smell, and we feel. Oh, not always directly, but in one way or another business is there. It's like the air that we breathe—mostly invisible, but always present.

The next part of the challenge is this: As you work through this first section, keep trying to think of something, *anything*, that you can say with certainty has *no* relationship to business. We will check back later and see what you came up with!

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1.2: What is Business?

What you'll learn to do: explain the concept of business

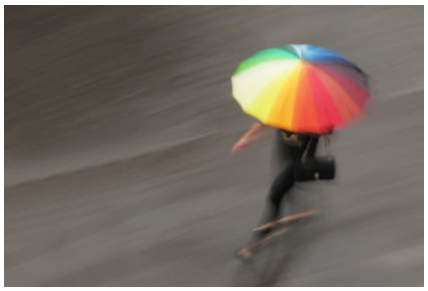
The concept of business has enough definitions and applications that we could almost say that everything is business. Throughout this course we will explore the various functions, roles, and characteristics of business while keeping in mind that business is like the air we breathe—it's everywhere!

Learning Objectives

- Distinguish between profit, loss, and value
- Distinguish between goods and services

Getting Down to Business

Today's Business Environment



The world of business today can be summed up in a single word: change. And not just change, but rapid change. in order to remain profitable and competitive, businesses today are finding that they need to be more responsive than ever to customer demands. This is not only true of big companies like Apple, Nike, and Whole Foods but of smaller businesses, too—like your local hardware or grocery store. The rapidly changing business environment affects them all.

What is the business environment? In some ways it resembles the natural environment in which we live: It's all around us but not always noticeable. It includes things like technology, competitors (other businesses), advertising, regulations, consumer demands, and money. When these elements of the business environment change—in the same way that seasons and weather change—companies need to be able to predict, react, and adapt accordingly. Those who fail to do so may find themselves out in the rain or cold and struggling to survive.

Although the environment in which businesses operate is always changing, the accelerated pace of change presents special challenges and opportunities for businesses today. To get a sense of this rapid and dramatic change, consider something that's fairly routine for Americans: getting a prescription filled. A couple of decades ago, you would have taken a written prescription from your doctor to your local drugstore and presented it to the pharmacist. Then, while waiting for it to be filled, you might have leafed through magazines or browsed the store for extra items—perhaps shampoo or a greeting card. When your name was called, you probably paid in cash or wrote a check. All such transactions took place during normal business hours—Monday–Friday, 9 am–5 pm; larger pharmacies may have been open for a few hours on Saturday.

What about now? Think about the last time you had a prescription filled. Did you ever even see it? Chances are you went to the doctor, and at the end of your visit she faxed the prescription straight to the pharmacy (perhaps a Rite-Aid, Walgreen's, or Duane Reed). A little while later, you may have received a text message notifying you that your prescription was ready. Since it wasn't convenient for you to pick it up during the workday, and because it's a 24-hour pharmacy, you went at night. You pulled up to the drive-through window and paid using Apple Pay or Google Wallet. Afterward you verified that you received points on your customer loyalty card, which means savings or cash that can be applied to future purchases. You never set foot inside the store.

Alternatively, you may have gotten your prescription filled online and mailed right to your home by a national discount supplier or maybe chosen to pick it up at Walmart or Target when you stopped in to shop for a new garden hose.

You can see from this example that the way companies "do business" is very different today. Some of these changes are the result of developments in technology, while others are the result of shifting consumer demands and trends. Regardless of the particular cause, though, all businesses have to cope with the changing nature and pressures of the business environment. A large part of this course will focus on the ways in which they do just that.

Defining Business

So, what is this thing we call “business”? A **business** is any activity that provides goods or services to consumers for the purpose of making a profit. Examples of **goods** provided by a business are tangible items such as cars, televisions, or soda. A **service** is a consumable, one-time benefit. Services include things such as haircuts, hotel stays, or roller-coaster rides. Business can generate profits from the sale of goods and/or services, and profits are the financial reward that comes from taking the risk of running or owning a business. More specifically, **profit** is the amount of revenue or income that a business owner retains after paying all the expenses associated with the operation of the business. If the expenses of the business exceed the revenue or income generated from operations, then the business will suffer a **loss**. Businesses that suffer extraordinary losses during a short period of time, or slowly see their profits decline, may end up closing or filing for bankruptcy.

Clearly the goal of most businesses is to generate a profit by increasing revenue while holding expenses in check, and one of the chief ways they do this is by providing their customers with value. When businesses talk about **value**, they are referring to the relationship between the price a customer pays for the good or service and the perceived benefits the customer receives in exchange for his or her time and money. Value has become such a key component of today’s business model that if you go to almost any fast-food restaurant you’ll find a “value meal” or “value menu” advertised. Such businesses are sending the message to their customers that they’ll receive the most “bang for the buck” or the highest value in terms of quantity obtained in exchange for money spent. It’s a business model based on the belief that if you give your customers value, the profit will follow. As you’ll see in the next section, while all businesses seek to increase their revenue, what a business actually does with those funds can vary and depends on whether it’s a for-profit or nonprofit organization.

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1.3: For-Profit vs. Nonprofit

What you'll learn to do: distinguish between for-profit and nonprofit businesses

We defined business earlier as an organization that provides goods, service, or both to their customers, clients, or consumers in order to make a profit. That definition, although accurate, does not account for those organizations and businesses that aren't *driven* by the "bottom line" or profitability. Instead, some organizations provide their goods and services in order to generate revenues (income) that can be used to further their purpose or mission. It is highly likely that you have been involved with a nonprofit organization, and though it may not have seemed like it at the time, you were actually working with a business! In this section we'll dig a little deeper into this idea of for-profit versus nonprofit business.

Learning Objectives

- Explain the purpose of for-profit businesses
- Explain the purpose of nonprofit businesses/organizations
- Distinguish between for-profit and nonprofit businesses

Profits and Purpose

A **nonprofit** or **not-for-profit business** is one that provides goods or services to consumers, but its primary goal is not to return profit to the owners of the business (as is the case with a for-profit business). Instead, it uses those profits to provide a public service, advance a cause, or assist others. The American Red Cross, the local SPCA, and the American Cancer Society are all examples of nonprofit businesses. They use any revenue generated from operations to support the continued mission of the organization. In addition, most nonprofits also rely on donations from individuals and businesses, grants, and government funding to help fund their work, since the revenue they raise rarely covers all their operating costs.

Much of what differentiates a for-profit business from a nonprofit business goes on behind the scenes and isn't very visible to the customer. For example, a nonprofit organization is subject to government regulation and oversight in ways that differ significantly from a for-profit business: Nonprofits do not pay taxes on their revenue, but how their funds are disbursed and their operations are managed is tightly regulated.

Profit and non-profit Lemonade stands

Profit and Non-Profit Lemonade Stands

Despite their differences, nonprofits and for-profits have some fundamental business principles and practices in common. Let's explore these shared aspects by comparing two businesses—one for-profit and one nonprofit.

Molly opens a lemonade stand in front of a local museum and intends to use her profits to purchase a new bike at the end of the summer. There are expenses associated with Molly's business such as lemons, sugar, cups, and ice. She also spends money on advertising when she prints up flyers and makes directional signs to alert customers to her location. She hires Jamie to help her on busy weekends and pays her a percentage of the stand's revenue on the days she works. She has T-shirts printed at a local shop with her slogan on the back: "When life gives you lemons, Molly makes lemonade." She sells the shirts at her stand for $10 each. A local bakery owner sees that Molly's business is thriving and asks if she can sell her cookies at the lemonade stand. Molly arranges to sell the cookies for the bakery and keep 25 percent of the revenue generated from cookie sales.

Molly is running a for-profit business and generates revenue from several sources (lemonade, T-shirts, and cookies). Every day, after packing up her stand, she goes home and calculates her profit by subtracting her expenses (wages to Jamie, advertising, T-shirts, and supplies) from her revenue. She takes the profit and deposits it in the bank account her father helped her open.

At the end of the summer, Molly can withdraw the money from the bank account and buy the bike she wants. If she has profits left after she buys the bike, she can do whatever she wants with that money. As a for-profit business owner, she owns all the profits.

Emma opens a lemonade stand in front of a local museum and intends to donate her profits to the local Humane Society to support their Feline Hope program. Besides that difference of purpose, Emma's business is nearly identical to Molly's: There are expenses

associated with Emma's business such as lemons, sugar, cups, and ice. Emma spends money on advertising when she prints up flyers and makes directional signs to alert customers to her location. She hires Linda to help her on busy weekends and pays her a percentage of the stand's revenue on the days she works. She has T-shirts printed at a local shop with her slogan on the back: "When life gives you lemons, Emma makes lemonade." She sells the shirts at her stand for $10 each. A local bakery owner sees that Emma's business is thriving and asks if she can sell her cookies at the lemonade stand. Emma arranges to sell the cookies for the bakery and keep 25 percent of the revenue generated from cookie sales.

Emma is running a not-for-profit business and generates revenue from several sources (lemonade, T-shirts, and cookies). Like Molly, after packing up her stand, she goes home and calculates her profit by subtracting her expenses (wages to Linda, advertising, T-shirts, and supplies) from her revenue. She takes the profit and deposits it in the bank account her father helped her open.

At the end of the summer, Emma can withdraw the money from the bank account and deliver a check to the Humane Society. If the business has profits in excess of what she promised to donate to the Humane Society, Emma can pay herself a *small* wage for running the business all summer, but the majority of the profits will either need to stay in the bank account to fund future causes or be used to expand the business to support charitable or social causes later on. Emma isn't really a business "owner," because she doesn't own the profit generated by the business. We'd expect to hear Emma say that she's *running* a not-for-profit (or nonprofit) *organization*—in contrast to Molly, who would probably say that she owns a business.

Although these may be very simple examples, they show that, from a customer's perspective, there is virtually no difference in the way the two businesses operate. Emma might decide to advertise that her proceeds support an important cause (the Humane Society's Feline Hope program) as a way of attracting

Although these may be very simple examples, they show that, from a customer's perspective, there is virtually no difference in the way the two businesses operate. Emma might decide to advertise that her proceeds support an important cause (the Humane Society's Feline Hope program) as a way of attracting customers. If not, the two lemonade stands would seem nearly identical from the outside.

It's not until you look behind the scenes that you will see the differences between a for-profit and nonprofit business. The following table compares the attributes of for-profit and not-for-profit businesses and highlights some of the "hidden" differences.

For-Profit	**Not-for-Profit/Nonprofit**
Incurs expenses for operations	Incurs expenses for operations
Provides goods and services to customers	Provides goods and services to customers
Generates revenue from sales	Generates revenue from sales **and/or contributions**
Owned by individuals, partners, or shareholders	**Operated by board of directors, trustees, and managers**
Profit is used to pay owners, partners, or shareholders	Profit is used to further the mission of the organization
Pays salaries to employees and managers	Pays salaries to employees and managers
Profits are subject to taxation by local, state, and federal authorities	**Profits are NOT subject to taxation by local, state, and federal authorities**

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1.4: Factors of Production

What you'll learn to do: list and explain the four factors of production required to sustain a business

When businesses use resources to produce things we call these factors of production. In this section we will examine the factors of production and see how they contribute to the outputs of a business.

learning Objectives

- Explain the four factors of production

Factors of Production

All businesses, both for-profit and nonprofit, need resources in order to operate. Simply put, resources are the **inputs** used to produce **outputs** (goods and/or services). Resources are also called **factors of production**. What makes something a resource? For one thing, it needs to be *productive*.

The following video will give you an overview of what economists mean when they talk about resources or factors of production.

There are four categories of resources, or factors of production:

- Natural resources (land)
- Labor (human capital)
- Capital (machinery, factories, equipment)
- Entrepreneurship

Natural Resources

Natural resources have two fundamental characteristics: (1) They are found in nature, and (2) they can be used for the production of goods and services. In order to provide benefit, people first have to discover them and then figure out how to use them in the the production of a good or service. Examples of natural resources are land, trees, wind, water, and minerals

A key feature of natural resources is that people can't make them. They also tend to be limited. New natural resources—or new ways of extracting them (such as fracking, for example)—can be discovered, though. These natural resources can be renewable, such as forests, or nonrenewable, such as oil or natural gas. It's also possible to invent new uses for natural resources (using wind to

generate electricity, for example). Resources that are cultivated or made with human effort can't be considered *natural* resources, which is why crops aren't natural resources.

Labor

Labor refers to human resources (also called human capital)—physical or intellectual. You're adding to your own human resources right now by learning. You may possess certain human resources already—perhaps you have an athletic gift that enables you to play professional ball to earn a living, for example—but you can also develop them through job training, education, experience, and so on.

The word **labor** often calls to mind physical labor—working in a factory or field, constructing a building, waiting tables in a restaurant—but it can refer to any human input (paid or unpaid) involved in the production of a good or service. This broader definition of labor is particularly important in today's technology-driven business environment, which has come to rely much more on the intellectual contributions of the labor force than the physical labor required of, say, working in a production line. Intellectual contributions include experience in and out of school, training, skills, and natural abilities. In order to remain competitive, businesses place a premium on employees who bring these "soft skills" to the table. Many of the advances in our world today are the result of the application of intellectual human resources.

Finally, labor brings creativity and innovation to businesses. Businesses use human creativity to address changes in consumer preferences and to invent goods and services that consumers haven't even imagined yet. Without creativity, innovation would stall, and economies would stagnate.

Capital

Before we discuss **capital**, it's important to point out that money is *not* a resource. Remember that resources need to be *productive*. They have to be used to make something else, and money can't do that. Money certainly helps the economy move along more efficiently and smoothly, like grease for the economic machine. But in and of itself, it can't produce anything. It's used to acquire the productive resources that can produce goods and services. This confusion is understandable, given that businesspeople frequently talk about "financial capital," or "investment capital," which does mean money.

In contrast to natural resources, capital is a resource that *has been* produced but is also used to produce *other* goods and services. This factor of production includes machinery, tools, equipment, buildings, and technology. Businesses must constantly upgrade their capital to maintain a competitive edge and operate efficiently. In the last couple decades or so, businesses have faced unprecedented technological change and have had to meet the demands of consumers whose lives increasingly take place in a virtual world. Almost every business has a Web presence, and many customers are more accustomed to interacting with a virtual version of the business than a brick and mortar store.

Entrepreneurship

Thus far we have looked at natural resources, human resources, and capital as three inputs needed to create outputs. The last one we need to consider is perhaps the most important: **entrepreneurship**. This resource is a special form of labor provided by an entrepreneur. An entrepreneur is someone who is willing to risk his or her time and money to start or run a business—usually with the hope of earning a profit in return. Entrepreneurs have the ability to organize the other factors of production and transform them into a business. Without entrepreneurship many of the goods and services we consume today would not exist.

Let's return to the example given at the beginning of this section: baking a cake.

Table 1.4.1. Factor of Production

Natural Resource	Wind is harnessed to produce electricity that powers the electric mixer and oven.
Human Resource	The baker's labor combined with the creativity and skills needed to actually bake and decorate it

Capital	Ovens, cake pans, flour, sugar, butter, and other ingredients used to make the cake
Entrepreneurship	An individual who starts the bakery or runs a home-based business baking and selling cakes to customers

If you consider just *some* of the factors of production involved in baking even a very simple cake, what would happen if one of the four inputs were missing? What if you lacked electricity or an oven? What if you lacked the skills to bake or decorate the cake? What if you had the first three factors of production but not the fourth, entrepreneurship? You can surmise that **all four** factors of production are required to create the outputs that would get you into the cake business—or any business.

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1.5: Functional Areas

What you'll learn to do: identify the primary functional areas within a business and describe their contribution to the organization

The decisions about how best to use the factors of production to provide the goods or services of the business require a team of people working in a variety of jobs. As businesses grow larger and their products and services become more complex, the number of functional areas within a business grows. Each functional area makes specific and valuable contributions to the organization as a whole. In this section we will explore some of the most common functional areas in a business and how each contributes to the overall success of the business.

Learning Objectives

- Identify key people and explain the activities within each functional area

Functional Areas of Business

Just as different functions in the human body are performed and regulated by different organs, different functions within a business are performed and controlled by different parts of the business. One of the reasons for separating business operations into functional areas is to allow each to operate within its area of expertise, thus building efficiency and effectiveness across the business as a whole. The key functional areas of a business are the following:

- Management
- Operations
- Marketing
- Accounting
- Finance

Management

The primary role of managers in business is to supervise other people's performance. Most management activities fall into the following categories:

- **Planning**: Managers plan by setting long-term goals for the business, as well short-term strategies needed to execute against those goals.
- **Organizing**: Managers are responsible for organizing the operations of a business in the most efficient way, enabling the business to use its resources effectively.
- **Controlling**: A large percentage of a manager's time is spent controlling the activities within the business to ensure that it's on track to achieve its goals. When people or processes stray from the path, managers are often the first ones to notice and take corrective action.
- **Leading**: Managers serve as leaders for the organization, in practical as well as symbolic ways. The manager may lead work teams or groups through a new process or the development of a new product. The manager may also be seen as the leader of the organization when it interacts with the community, customers, and suppliers.

Operations

Operations is where inputs (factors of production) are converted to outputs (goods and services). Operations is like the heart of a business, pumping out goods and services in a quantity and of a quality that meets the needs of the customers. The **operations manager** is responsible for overseeing the day-to-day business operations, which can encompass everything from ordering raw materials to scheduling workers to produce tangible goods.

Marketing

Marketing consists of all that a company does to identify customers' needs and design products and services that meet those needs. The marketing function also includes promoting goods and services, determining how the goods and services will be delivered, and developing a pricing strategy to capture market share while remaining competitive. In day's technology-driven business environment, marketing is also responsible for building and overseeing a company's Internet presence (e.g., the company Web site,

blogs, social media campaigns, etc.). Today, social media marketing is one of the fastest growing sectors within the marketing function.

Accounting

Accountants provide managers with information needed to make decisions about the allocation of company resources. This area is ultimately responsible for accurately representing the financial transactions of a business to internal and external parties, government agencies, and owners/investors. **Financial Accountants** are primarily responsible for the preparation of financial statements to help entities both inside and outside the organization assess the financial strength of the company. **Managerial accountants** provide information regarding costs, budgets, asset allocation, and performance appraisal for internal use by management for the purpose of decision-making.

Finance

Although related to accounting, the finance function involves planning for, obtaining, and managing a company's funds. **Finance managers** plan for both short- and long-term financial capital needs and analyze the impact that borrowing will have on the financial well-being of the business. A company's finance department answers questions about how funds should be raised (loans vs. stocks), the long-term cost of borrowing funds, and the implications of financing decisions for the long-term health of the business.

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1.6: Stakeholders

What you'll learn to do: identify business stakeholders and describe their relationship with business organizations

Just as it takes many parts to make a business run smoothly, there are many people, organizations, and entities that have a "stake" in the success of a business. In this section we'll take a look at who these stakeholders are and how they affect business.

Learning Objectives

- Describe stakeholders' relationship with business organizations

What Is a Stakeholder?

A **stakeholder** is an individual or group that has a legitimate interest in a company, organization, or business; the Stanford Research Institute defines stakeholders as "those groups without whose support the organization would cease to exist. Stakeholders can affect or be affected by the actions (or inactions) of a business, and they can exist both within and outside of a business.

The impact of a business on its stakeholders is a bit like the effect of dropping a stone into a pond. The decisions and actions of the business have a ripple effect that can extend beyond the pond and even reach those who are standing far away on the shore.

Internal Stakeholders

Internal stakeholders are groups or people who work directly within the business, such as managers, employees, and owners. Managers and employees want to earn high wages and keep their jobs, so they have a vested interest in the financial health and success of the business. Owners want to maximize the profit the business makes as compensation for the risks they take in owning or running a business.

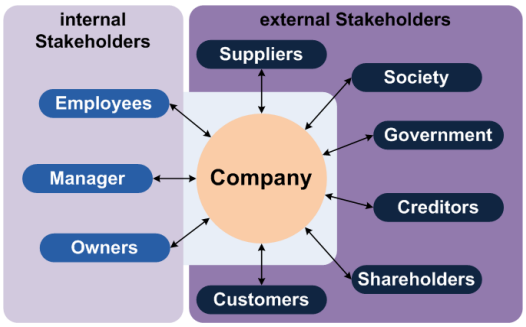

Figure 1.6.1. The picture shows the typical stakeholders of a company. The stakeholders are divided into internal and external stakeholders.

External Stakeholders

External stakeholders are groups outside a business or people who don't work inside the business but are affected in some way by the decisions and actions of the business. Examples of external stakeholders are customers, suppliers, creditors, the local community, society, and the government. **Customers** want the business to produce quality products at reasonable prices. **Shareholders** have an interest in business operations since they are counting on the business to remain profitable and provide a return on their investment in the business. **Creditors** that supply financial capital, raw materials, and services to the business want to be paid on time and in full. **Federal, state, and local governments** need businesses to thrive in order to pay taxes that support government services such as education, police, and fire protection. The **local community** has a stake in the business because it provides jobs, which generate economic activity within the community. **Society** as a whole (as well as the local community) is concerned about the impact that business operations have on the environment in terms of noise, air, and water pollution. Society also has an interest in the business with regard to the safety of the goods and services produced by the business. **Suppliers** need the business to continue to buy their products in order to maintain their own profitability and long-term financial health.

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1.7: External Forces

What you'll learn to do: identify the external forces that shape the business environment

You are probably aware that businesses do not operate in a vacuum, immune to the forces that shape our everyday life. Just like people, businesses interact with their surroundings, and just like people, businesses react differently to their environment. Later in the course, you will explore these external forces in greater depth when you complete modules covering topics such as the global business environment, business ethics, and marketing. For the time being, this section will introduce the external forces that have an impact on business operations and decisions and serve as a foundation for things to come.

Learning Objectives

- Give examples of how various external forces affect the participants in a business and its functional areas

External Forces That Shape Business Activities

Businesses do not operate in a vacuum, and they are influenced by forces beyond their control. How they respond—and how quickly they respond—to these external forces can make the difference between success and failure, especially in today's fast-paced business climate. We can organize the external forces that affect business into the following six categories:

1. Economic environment
2. Legal environment
3. Competitive environment
4. Technological environment
5. Social environment
6. Global environment

Businesses operate in all of these environments simultaneously, and factors in one environment can affect or complicate factors in another.

Economic Environment

The economic environment of business has changed dramatically in recent years. After decades of growth and dominance, the US economy is now challenged by the developing economies of other nations, which are jockeying to be number one. Since the financial crisis in 2008, the US economy and businesses have struggled to recover from the greatest economic crisis since the Great Depression of the 1930s. Long-established companies have closed their doors, costing workers their jobs, retirement savings, and even their homes. Thus far the US economy has proven resilient, and since the Great Recession in 2008, progress has been made to stabilize the housing industry, maintain low and affordable interest rates, and provide additional incentives for businesses to open and/or expand. These economic events have all had a direct impact on businesses, regardless of size.

Legal Environment

The legal environment of business is by far the most complex and potentially dangerous external factor a business faces. There is a minefield of regulations, laws, and liabilities that companies must cope with in order to stay in business—just turn on the TV or listen to the news to verify this fact. Volkswagen teeters on the brink of ruin because it falsified data about its cars' emissions. Tide is airing commercials not to promote the marvels of its laundry detergent but to warn parents to keep the Tide pods away from children, who may be tempted to eat them. These days it takes five minutes and a sharp instrument to open a bottle of Tylenol—the result of Johnson & Johnson's move in 1982 to make the product more difficult to open after a tampering incident in 1982 caused a spate of deaths and illness. Legal developments in our culture at large—for instance, the

legalization of marijuana and same-sex marriage or the strengthening of privacy laws—can and do have an enormous impact on the way companies do business, on everything from what companies sell to how their products are manufactured, labeled, and marketed.

Competitive Environment

How do businesses stay competitive and still maintain a level of profitability that allows them to be successful? The competitive environment has intensified with the development of new technologies, the opening up of foreign markets, and the rise of consumer expectations. The local hardware store now finds itself competing with "big box" stores such as Lowe's and Home Depot. These larger stores have enough clout with suppliers that they can often sell a product to the consumer for less than an independent store can purchase it. Customers of these large chains can order online, get their items the same day, and receive loyalty rewards, free delivery, customization, and even service and installation. Staying competitive is a challenge for every business, and business owners are finding that benefits such as customer service, employee knowledge, and high quality can help them survive.

Technological Environment

Almost daily, businesses are driven to rethink the business technology they use to reach customers, produce their products, and provide their services. When we refer to **business technology** we mean digital tools such as computers, telecommunications, and the Internet. The expansion of Internet access to virtually every corner of the world has forced many traditional brick-and-mortar businesses into **e-commerce** or online sales. The advantage to businesses is that their customers no longer have to live in proximity to their stores in order to purchase goods and services. Consumers can conveniently shop for products and services without leaving their home, their desk, or their phone. The disadvantage to businesses is that consumers are also able to compare competitors' prices, benefits, features, and services (which shows how one environment—technology—can affect another—the competitive environment). Today's businesses have to be vigilant about spotting emerging trends not only in technology but in the way consumers use that technology.

Social Environment

The social environment of business encompasses the values, attitudes, beliefs, wants, and desires of the consuming public. The **demographics** that describe the American population by gender, age, ethnicity, location, occupation, education and income are constantly evolving. The American population is steadily becoming more ethnically diverse: The US Census Bureau estimates that the Hispanic and Asian populations in the United States will double by 2050. At the same time, America is aging, and with the current median above thirty-six years of age, it will not be long before the majority of Americans is ready to retire. In addition to ethnic diversity and age, the social environment brings forces such as **Corporate Social Responsibility (CSR)**, which means that more and more consumers are demanding that businesses be "good corporate citizens" by supporting charitable causes and contributing to local communities, adhering to ethical standards in their treatment of workers and others, and adopting environmentally responsible practices. Combine these factors with the whirlwind of changing fads, trends, and "hot topics," and you have some idea of why the social environment can present the greatest challenge to business.

Global Environment

From a business perspective, it is a small world, and it's only getting smaller. **Free trade** among nations has allowed goods and services to flow across international borders more efficiently and cheaply. Formal trade agreements among nations have forged unprecedented links and interdependencies among economies. Look at the items on your desk, and you may see items from China, Mexico, Canada, or Japan. It's possible that you drive a car that was made in the United States but was produced in a plant owned by a Japanese company. The growth of the Chinese economy has brought a flood of affordable goods into the United States and, along with those cheaper prices, created a reliance on foreign goods and materials. Now, when the Chinese economy slows down, the US economy is affected. When the price of foreign oil increases or decreases, businesses in the United States feel the impact. So, it's not just the local economy or even the national economy that businesses must track—they must also keep an eye on the world economy in order to anticipate and adapt to changes that will impact their products and services.

Figure 1.7.1. Business and its environment

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1.8: Putting it Together-Role of Business

Synthesis

Now that you have been exposed to some of the terms and definitions we use in business, have you been able to find something that doesn't have a link back to business? Let's go back to where we started.

If you were in your living room, then everything in your surroundings was most likely manufactured by a business for your use—chairs, television, computer, pens, pencils.

What if you had been at the coffee shop? Well, this one is easy because you were doing your studying in a business, surrounded by people working for a business who were serving the customers of the business.

The last possibility we suggested was the beach. Well, the ocean doesn't have anything to do with business, does it? Remember in the module we talked about nonprofit organizations as business entities. Aren't there organizations that use their profits to support clean water and preservation of the coastline? What about the lifeguards at the beach who are paid by a business to keep swimmers safe? Where did the children get the shovels and pails they were using to play in the sand?

By this time you should begin to see that even though you may not think of business as you go about your daily routine, it is always there, like the air we breathe. Throughout this text you will learn about how businesses operate, why they engage in the activities they do, and numerous other components that go into this thing we call "business."

In the meantime, don't stop looking for something that qualifies as "non-business related"—you might find something after all.

Summary

This module covered the role of business. Below is a summary of the topics covered in this module.

What Is Business?

We defined business as any kind of organization or action that creates goods or provides services. While this is usually undertaken with making a profit as the main goal, though this isn't always the case.

For-Profit vs. Non-Profit

For-profit businesses focus on earning a profit. They are concerned with the company's well-being and success above all else. Non-profit organizations, on the other hand, are more goal-oriented. They are concerned with communities or members. Instead of focusing on earning money, NPOs focus on their customers and their needs (e.g., credit unions, sports clubs, human service programs, aid and development programs).

Factors of Production

In order to produce services or goods, a business needs four resources: land (or other natural resources), labor, capital, and entrepreneurship. Natural resources are defined as resources found in nature unaltered by man; these include oil, wind, trees, and so on. Labor can be divided into two general categories: physical labor and mental labor. Both kinds of work are necessary for success. Capital includes things created by human beings that are used to make other goods: power tools, computers, and even art (which can be used to create museums or art shows). Money is not considered to be capital. An entrepreneur is the person who starts the company or business—without him or her, the business would not exist to begin with.

Functional Areas

Businesses are made up of functional areas—different activities that need to be done to maintain the business. These include management, operations, marketing, accounting, and finance. Management ensures employees are on task and that each employee is being leveraged in the way that makes the business most efficient. Operations watches over production and ensures quality of product. Marketing brings in customers, both by making the business look appealing to customer and by taking customer feedback and improving the business. Accounting keeps track of the money currently coming in and the money currently being spent. Finance plans for future expenses and income.

Stakeholders

There are two kinds of stakeholders (individuals who have a vested interest in a company): internal stakeholder and external stakeholders. Internal stakeholders include employees, managers, and owners. These individuals are vested in the company because they directly depend on it for income. External stakeholders include customers, shareholders, creditors, suppliers, and others. These people have a legitimate interest in the company for various reasons and can all be affected by actions the business takes.

External Forces

A business is not just influenced by itself—everything in the world around it can impact a business. A business may create a fun new toy, but if the economy is suffering and consumers aren't buying a lot of things they do not need, the business most likely won't succeed. Business can be affected by the economy, consumer trends, government regulations, and many other things.

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CHAPTER OVERVIEW

2: Economic Environment

2.1: Why it Matters- Economic Environment
2.2: What is Economics
2.3: Economic Systems
2.4: Demand
2.5: Supply
2.6: Equilibrium
2.7: The Health of the Economy
2.8: Economic Stages
2.9: Putting It Together- Economic Environment

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2.1: Why it Matters- Economic Environment

Why learn about fundamental economic principles?

Economics is about choices: namely, how we choose to allocate scarce resources and how our choices impact others. Beyond that, it's about the choices made by businesses, government, and other countries. Let's begin with ice cream—something familiar and tasty to most people—and use it as a framework for thinking about economics.

Let's say you live in Boise, Idaho, and decide to go out for ice cream with your friend Charlie, who has been reading about ice cream flavored with Persian saffron. That's the kind he wants, but none of the five ice-cream shops you visit has it. Why not? Why can't they meet his demand? Because Charlie is the only person in Boise who has ever asked for it, and none of the shops has decided to carry something so expensive (the saffron costs nearly $1,000 per ounce) and, frankly, strange. They have chosen to offer ice cream that is low-cost, high-demand, and easy to manufacture.

The next day, Charlie is still obsessed with saffron ice cream, and he's discovered a shop in Dubai, where, for the mere price of $816 (per scoop, fancy toppings included), one can try this exotic treat. Now Charlie has some economic choices to make. Including the $1,800 airfare, plus the other travel expenses (hotel, cabs, etc.), the trip to Dubai will cost $2,600—at least. It will also cost Charlie time: the time it takes to plan the trip, the days off work, and travel time. Then, there's the opportunity cost. While he is planning, traveling, and eating his ice cream, Charlie's giving up the opportunity to do other things with his time and money. And there are unforeseen choices and expenses: What if he gets to Dubai and they've run out of saffron ice cream? Does he hang around in Dubai, investing more resources and waiting for them to restock? What if he tries Persian saffron ice cream and says, "Yuck!"—and wishes he'd bought banana ice cream back in Boise?

This is an extreme, unlikely situation, of course. However, the choices that ice-cream manufacturers, ice-cream shops, and people like Charlie make every day are all examples of economic decisions: at every turn, a choice has to be made about the allocation of limited resources. What economic decisions do you make in your life?

The purpose of this module is to give you an understanding of the fundamental principles of economics, some of the factors that drive economies, and how economics shapes the business environment. You will likely learn more about economics as you continue your education, but this section should serve as an excellent introduction and give you some tools to think about the impact of economics on your daily life.

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2.2: What is Economics

What you'll learn to do: explain what economics is and why it's important

In order to understand economics it's important to master a set of key concepts and understand how they interconnect. We'll cover these concepts next.

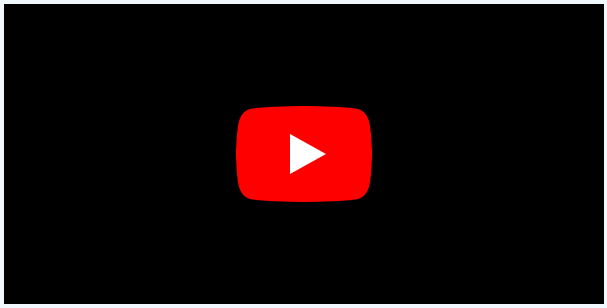
Learning Objectives

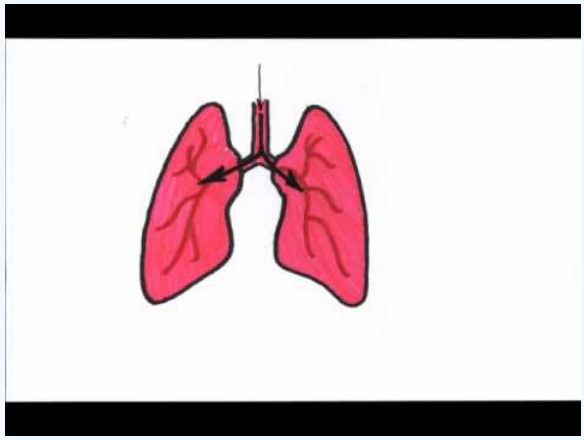
- Explain opportunity cost
- Distinguish between macroeconomics and microeconomics

Understanding Economics and Scarcity

Watch it

Throughout this module you'll encounter short videos that explain complex economic concepts in very simple terms. Take the time to watch them! They'll help you master the basics before heading to the readings (which tend to cover the same information in more depth).





As you watch the video, consider the following key points:

1. Scarcity exists when human wants for goods and services exceed the available supply.
2. People make decisions in their own self-interest, weighing benefits and costs.

Scarcity

The resources that we value—time, money, labor, tools, land, and raw materials—exist in limited supply. There are simply never enough resources to meet all our needs and desires. This condition is known as scarcity.

At any moment in time, there is a finite amount of resources available. Even when the number of resources is very large, it's limited. For example, according to the U.S. Bureau of Labor Statistics, in 2016, the labor force in the United States contained more than 158 million workers—that's a lot, but it's not infinite. Similarly, the total area of the United States is 3,794,101 square miles—an impressive amount of acreage, but not endless. Because these resources are limited, so are the numbers of goods and services we can produce with them. Combine this with the fact that human wants seem to be virtually infinite, and you can see why scarcity is a problem.

Economics

When faced with limited resources, we have to make choices. Again, economics is the study of how humans make choices under conditions of scarcity. These decisions can be made by individuals, families, businesses, or societies.

Let's consider a few decisions that we make based on limited resources. Take the following:

Question 1: *What classes are you taking this term?*

Are you the lucky student who is taking every class you wanted with your first-choice professor during the perfect time and at the ideal location? The odds are that you have probably had to make trade-offs on account of scarcity. There is a limited number of time slots each day for classes and only so many faculty available to teach them. Every faculty member can't be assigned to every time slot. Only one class can be assigned to each classroom at a given time. This means that each student has to make trade-offs between the time slot, the instructor, and the class location.

Question 2: *Where do you live?*

Think for a moment, if you had all the money in the world, where would you live? It's probably not where you're living today. You have probably made a housing decision based on scarcity. What location did you pick? Given limited time, you may have chosen to live close to work or school. Given the demand for housing, some locations are more expensive than others, though, and you may have chosen to spend more money for a convenient location or to spend less money for a place that leaves you spending more time on transportation. There is a limited amount of housing in any location, so you are forced to choose from what's available at any time. Housing decisions always have to take into account what someone can afford. Individuals making decisions about where to live must deal with limitations of financial resources, available housing options, time, and often other restrictions created by builders, landlords, city planners, and government regulations.

The Problem of Scarcity

Every society, at every level, must make choices about how to use its resources. Families must decide whether to spend their money on a new car or a fancy vacation. Towns must choose whether to put more of the budget into police and fire protection or into the school system. Nations must decide whether to devote more funds to national defense or to protecting the environment. In most cases, there just isn't enough money in the budget to do everything.

Economics helps us understand the decisions that individuals, families, businesses, or societies make, given the fact that there are never enough resources to address all needs and desires.

Practice question 2.2.1

Suppose that a family decides to spend all of their available money on a fancy vacation instead of purchasing a much needed new automobile. From an economist's perspective, which of the following statements about this decision is likely to be true?

a. The decision is irrational because anyone can see that choosing a vacation over a much needed new automobile is an improper use of scarce resources

b. The decision is rational in the sense that it reflects the family's preference for vacations over new automobiles.
c. The decision must have been made haphazardly and is therefore irrational.

Answer

b is correct - Economists have to make board assumptions about behavior and therefore choices of individual agents under conditions of scarcity. If the family decides to take the vacation instead of the automobile economists must assume that it reflects their preferences even if the decision may seem irrational to outside observers

a is incorrect - Explaining economic behavior should not include qualitative judgements of decisions made by individuals or households. The family has revealed its preference for vacations over automobiles and economists must assume that this is rational behavior.

c is incorrect - While it could be that the family drew lots to make their choice, economists must assume that even the choosing of lots to decide on what to do with their scarce resources is rational behavior

The Concept of Opportunity Cost

Since resources are limited, every time you make a choice about how to use them, you are also choosing to forego other options. Economists use the term **opportunity cost** to indicate what must be given up to obtain something that's desired. A fundamental principle of economics is that every choice has an opportunity cost. If you sleep through your economics class (not recommended, by the way), the opportunity cost is the learning you miss. If you spend your income on video games, you cannot spend it on movies. If you choose to marry one person, you give up the opportunity to marry anyone else. In short, opportunity cost is all around us.

The idea behind opportunity cost is that the cost of one item is the lost opportunity to do or consume something else; in short, opportunity cost is the value of the next best alternative.

Since people must choose, they inevitably face trade-offs in which they have to give up things they desire to get other things they desire more.

Opportunity Cost and Individual Decisions

In some cases, recognizing the opportunity cost can alter personal behavior. Imagine, for example, that you spend $8 on lunch every day at work. You may know perfectly well that bringing a lunch from home would cost only $3 a day, so the opportunity cost of buying lunch at the restaurant is $5 each day (that is, the $8 that buying lunch costs minus the $3 your lunch from home would cost). Five dollars each day does not seem to be that much. However, if you project what that adds up to in a year—250 workdays a year × $5 per day equals $1,250—it's the cost, perhaps, of a decent vacation. If the opportunity cost were described as "a nice vacation" instead of "$5 a day," you might make different choices.

practice Question 2.2.2

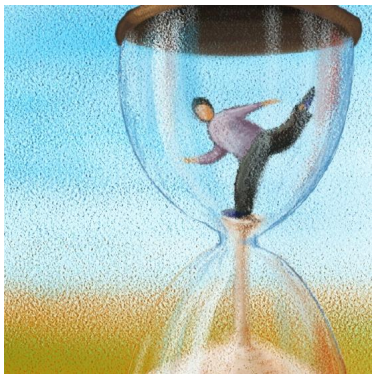
Take a stab at this question (you'll need to do some multiplication). Every day, 500,000 drivers in Los Angeles incur an additional 30 minutes of traffic delays when commuting by car to their jobs. In Boston, the delays amount to 45 minutes for 200,000 drivers. If the price of time is $15/hour in Los Angeles and $25/hour in Boston, which city incurs the largest opportunity cost?

a. Boston
b. Neither
c. Los Angeles

Answer

b. is correct - Costs in Los Angeles = 0.50 hours x 500,000 drivers at $15/hour implies a cost of $3,750,000. In Boston, 0.75 hours x 200,000 drivers at $25 per hour implies the same $3,750,000

Opportunity Cost and Societal Decisions



Opportunity cost also comes into play with societal decisions. Universal health care would be nice, but the opportunity cost of such a decision would be less housing, environmental protection, or national defense. These trade-offs also arise with government policies. For example, after the terrorist plane hijackings on September 11, 2001, many proposals, such as the following, were made to improve air travel safety:

- The federal government could provide armed "sky marshals" who would travel inconspicuously with the rest of the passengers. The cost of having a sky marshal on every flight would be roughly $3 billion per year.
- Retrofitting all U.S. planes with reinforced cockpit doors to make it harder for terrorists to take over the plane would have a price tag of $450 million.
- Buying more sophisticated security equipment for airports, like three-dimensional baggage scanners and cameras linked to face-recognition software, would cost another $2 billion.

However, the single biggest cost of greater airline security doesn't involve money. It's the opportunity cost of additional waiting time at the airport. According to the United States Department of Transportation, more than 800 million passengers took plane trips in the United States in 2012. Since the 9/11 hijackings, security screening has become more intensive, and consequently, the procedure takes longer than in the past. Say that, on average, each air passenger spends an extra 30 minutes in the airport per trip. Economists commonly place a value on time to convert an opportunity cost in time into a monetary figure. Because many air travelers are relatively highly paid businesspeople, conservative estimates set the average "price of time" for air travelers at $20 per hour. Accordingly, the opportunity cost of delays in airports could be as much as 800 million (passengers) × 0.5 hours × $20/hour —or, $8 billion per year. Clearly, the opportunity costs of waiting time can be just as substantial as costs involving direct spending.

practice question 2.2.3

Raising public transportation fares _____.

a. increases the opportunity costs of driving one's car.
b. increases the opportunity cost of taking public transportation
c. reduces the opportunity cost of driving one's car

Answer

c. is correct - An increase in public transport fares reduces the cost of driving ones car relative to taking public transportation

a is incorrect - Higher fares imply a reduction in the opportunity cost of driving.

b is incorrect - It increases the direct cost of taking public transportation but reduces the opportunity cost of taking any other alternative mode of transpor

Watch this video to see some more examples and to develop a deeper understanding of opportunity cost.

Division of Labor and Specialization

We have learned that there aren't enough resources to fulfill all of our wants and this reality forces us to make choices that have opportunity costs. How do we get the most we can from the resources we have? Over time, markets and trade have come into existence and have become highly efficient mechanisms for optimizing our use of resources and bringing us the most and best combination of goods and services.

Think back to pioneer days, when the average person knew how to do so much more on his or her own than someone today—everything from shoeing a horse to growing, hunting, and preserving food to building a house and repairing equipment. Most of us don't know how to do all—or any—of those things. It's not because we're not capable of learning them. It's because we don't have to. The reason for this is something called the "division and specialization of labor," a production innovation first put forth by Adam Smith.

The formal study of economics began when Adam Smith (1723–1790) published his famous book, *The Wealth of Nations*, in 1776. Many authors had written about economics in the centuries before Smith, but he was the first to address the subject in a comprehensive way.

In the first chapter of the book, Smith introduces the idea of the **division of labor,** which means that the way a good or service is produced is divided into a number of tasks that are performed by different workers, instead of all the tasks being performed by the same person. To illustrate the division of labor, Smith counted how many tasks were involved in making a pin: drawing out a piece of wire, cutting it to the right length, straightening it, putting a head on one end and a point on the other, packaging pins for sale, and so on. Smith counted eighteen distinct tasks that were typically performed by different people—all for a pin!

Modern companies divide tasks, too. Even a relatively simple business like a restaurant divides up the task of serving meals into a range of jobs: top chef, sous chefs, less-skilled kitchen help, host/hostess, waiters/waitresses, janitors, a business manager to handle accounts and paychecks, etc. A complex business like a large manufacturing factory or a hospital can have hundreds of job classifications.

practice question 2.2.4

Smith's theory of division and specialization of labor implies that a worker skilled in engineering will

a. improve economic output
b. negatively affect economic output if employed in anything but engineering
c. yield economic output that is sub-optimal if she were employed in something other than engineering-type functions

Answer

c. is correct - According to Smith, output is optimal when workers specialize in a part of the production process that they do best.

a is incorrect - There is no reason to suspect that the engineer is better at any task other than engineering such that output would increase.

b is incorrect - If the engineer works in some part of the production process that is other than engineering, output will be less than it could be but it will decline only if the engineer's skills are so poor in anything but engineering that the production process is interrupted.

Why the Division of Labor Increases Production

When the tasks involved with producing a good or service are divided and subdivided, workers and businesses can produce a greater quantity of those goods or services. In his study of pin factories, Smith observed that one worker alone might make twenty pins in a day, but that a small business of ten workers (some of whom would need to do two or three of the eighteen tasks involved in pin making), could make forty-eight thousand pins in a day. How can a group of workers, each specializing in certain tasks, produce so much more than the same number of workers who try to produce the entire good or service by themselves? Smith offered three reasons.

First, **specialization** in a particular small job allows workers to focus on the parts of the production process in which they have an advantage. People have different skills, talents, and interests, so they will be better at some jobs than at others. The particular advantages may be based on educational choices, which are shaped, in turn, by interests and talents. Only those with medical training qualify to become doctors, for instance. For some goods, specialization will be affected by geography—it's easier to be a wheat farmer in North Dakota than in Florida, but easier to run a tourist hotel in Florida than in North Dakota. If you live in or near a big city, it's easier to attract enough customers to operate a successful dry-cleaning business or movie theater than if you live in a sparsely populated rural area. Whatever the reason, if people specialize in the production of what they do best, they will be more productive than if they produce a combination of things, some of which they are good at and some of which they are not.

Second, workers who specialize in certain tasks often learn to produce more quickly and with higher quality. This pattern holds true for many workers, including assembly-line laborers who build cars, stylists who cut hair, and doctors who perform heart surgery. In fact, specialized workers often know their jobs well enough to suggest innovative ways to do their work faster and better. A similar pattern often operates within businesses. In many cases, a business that focuses on one or a few products is more successful than firms that try to make a wide range of products.

Third, specialization allows businesses to take advantage of **economies of scale,** which means that, for many goods, as the level of production increases, the average cost of producing each individual unit declines. For example, if a factory produces only one hundred cars per year, each car will be quite expensive to make on average. However, if a factory produces fifty thousand cars each year, then it can set up an assembly line with huge machines and workers performing specialized tasks, and the average cost of production per car will drop. Economies of scale implies that production is becoming more efficient as the scale of production rises.

The ultimate result of workers who can focus on their preferences and talents, learn to do their specialized jobs better, and work in larger organizations is that society as a whole can produce and consume far more than if each person tried to produce all of their own goods and services. The division and specialization of labor has been a force against the problem of scarcity.

practice question 2.2.5

Use the information you just read in the text to think about the following scenario. The computer software industry is more likely to achieve economies of scale if it is located

a. in or close to large cities with large numbers of technology workers.
b. in highly populated areas with an abundance of low skill workers
c. in geographical areas with the highest prevailing wages

Answer

a is correct - Being close to large cities will provide software makers with easier access to skilled labor than if located in a sparsely populated or rural area. This would enable software producers to build larger production facilities and therefore increase the likelihood of achieving economies of scale.

b is incorrect - Low skills imply that these workers are probably not well-matched to software production type jobs and therefore the software producers would face a labor shortage.

c is incorrect - While high wages may suggest a highly skilled workforce, it does not necessarily imply that such workers are well-suited to software production or that there are sufficient numbers of them.

Trade and Markets

Specialization only makes sense, though, if workers (and other economic agents such as businesses and nations) can use their income to purchase the other goods and services they need. In short, specialization requires trade. You do not have to know anything about electronics or sound systems to play music—you just buy an iPod or MP3 player, download the music, and listen. You don't have to know anything about textiles or the construction of sewing machines if you need a jacket—you just buy the jacket and wear it. Instead of trying to acquire all the knowledge and skills involved in producing all of the goods and services that you wish to consume, the market allows you to learn a specialized set of skills and then use the pay you receive to buy the goods and services you need or want. This is how our modern society has evolved into a strong economy.

practice question 2.2.6

An economy is composed entirely of two equally sized farms A and B producing both eggs and milk. Farm A is better at producing eggs than Farm B which is better at producing milk. Then in order to maximize output, Farm A should

a. Abandon the production of milk to fully specialize in the production of eggs and then trade with Farm B for milk
b. Produce both eggs and milk on its own and sell its excess eggs to B for additional milk.
c. Reduce its production of eggs in order to commit resources to learn how to better produce milk.

Answer

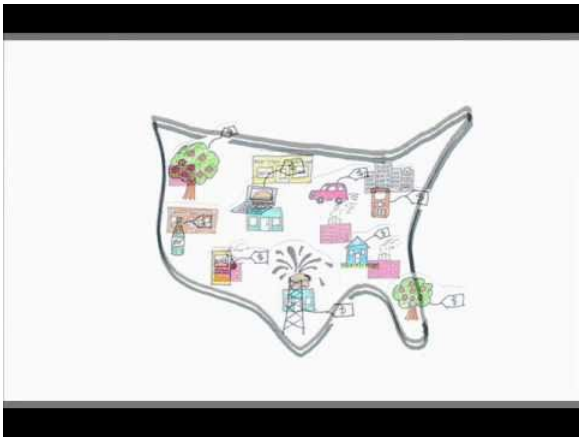
a is correct - According to Smith's theory Farm A should fully specialize in the production of eggs then trade eggs for milk. Since it can produce eggs more cheaply than B and B can produce milk more cheaply than A all resources are being efficiently utilized to maximize output.

b is incorrect - Any milk that Farm A produces is an inefficient use of its resources. In addition, when Farm A produces milk it prevents Farm B from realizing its full cost savings by limiting trade with A in milk. Recall that if Farm B has economies of scale in the production of eggs, its average costs will fall as output of milk rises. If these cost savings are unrealized the economy is worse off.

c is incorrect - By reducing its production of eggs, Farm A is undermining output for the entire economy. Farm B would need to increase its output of eggs but because it is not good at egg production, such an outcome would imply a proportionally large reduction in the output of milk.

Microeconomics and Macroeconomics

Economics is such a broad field of study that it is broken down into two subfields: microeconomics and macroeconomics. Microeconomics covers topics related to the actions of individual people or businesses within the economy while macroeconomics examines the larger economy and broader issues like GDP, inflation, growth rates, and trade. Watch this video to learn about the distinction between the two perspectives.



It should be clear by now that economics covers a lot of ground. That ground can be divided into two parts: **Microeconomics** focuses on the actions of individual agents within the economy, like households, workers, and businesses; **macroeconomics** looks at the economy as a whole. It focuses on broad issues such as growth, unemployment, inflation, and trade balance. Microeconomics and macroeconomics are not separate subjects but are, rather, complementary perspectives on the overall subject of the economy.

To understand why both microeconomic and macroeconomic perspectives are useful, consider the problem of studying a biological ecosystem like a lake. One person who sets out to study the lake might focus on specific topics: certain kinds of algae or plant life; the characteristics of particular fish or snails; or the trees surrounding the lake. Another person might take an overall view and instead consider the entire ecosystem of the lake from top to bottom: what eats what, how the system remains in balance, and what environmental stresses affect this balance. Both approaches are useful, and both researchers study the same lake, but the viewpoints are different. In a similar way, both microeconomics and macroeconomics study the same economy, but each has a different starting point, perspective, and focus.

Whether you are looking at lakes or economics, the micro and the macro insights should illuminate each other. In studying a lake, the “micro” insights about particular plants and animals help us to understand the overall food chain, while the “macro” insights about the overall food chain help to explain the environment in which individual plants and animals live.

In economics, the micro decisions of individual businesses are influenced by the health of the macroeconomy—for example, firms will be more likely to hire workers if the overall economy is growing. In turn, the performance of the macroeconomy ultimately depends on the microeconomic decisions made by individual households and businesses.

Microeconomics

What determines how households and individuals spend their budgets? What combination of goods and services will best fit their needs and wants, given the budget they have to spend? How do people decide whether to work, and if so, whether to work full time or part time? How do people decide how much to save for the future, or whether they should borrow to spend beyond their current means?

What determines the products, and how many of each, a firm will produce and sell? What determines what prices a firm will charge? What determines how a firm will produce its products? What determines how many workers it will hire? How will a firm finance its business? When will a firm decide to expand, downsize, or even close? In the microeconomic part of this text, we will learn about the theory of consumer behavior and the theory of the firm.

Macroeconomics

What determines the level of economic activity in a society or nation?—that is, how many goods and services does it actually produce? What determines how many jobs are available in an economy? What determines a nation’s standard of living? What causes the economy to speed up or slow down? What causes firms to hire more workers or lay them off? Finally, what causes the economy to grow over the long term?

An economy’s macroeconomic health can be assessed by a number of standards or goals. The most important macroeconomic goals are the following:

- Growth in the standard of living
- Low unemployment
- Low inflation

Macroeconomic policy pursues these goals through monetary policy and fiscal policy:

- **Monetary policy,** which involves policies that affect bank lending, interest rates, and financial capital markets, is conducted by a nation's central bank. For the United States, this is the Federal Reserve.
- **Fiscal policy**, which involves government spending and taxes, is determined by a nation's legislative body. For the United States, this is the Congress and the executive branch, which establishes the federal budget.

To keep the differences between these policies straight, remember that the term *monetary* relates to money, and the term *fiscal* relates to government revenue or taxes.

practice question 2.2.7

Government expenditures on public schools is classified as _____ policy.

a. monetary
b. fiscal
c. microeconomic

Answer

b is correct - it is still classified as fiscal policy since it is a government purchase of goods and services

practice question 2.2.8

Economic policy decisions taken by individual states within the U.S. are classified as _____ decisions.

a. microeconomic
b. macroeconomic
c. neither microeconomic or macroeconomic

Answer

b is correct - It is tempting to say microeconomic because it is one State making an economic decision within the broader national economy. However, the decision of the State affects all economic actors that live or operate within the State and therefore should be classified as macroeconomic.

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2.3: Economic Systems

What you'll learn to do: describe and differentiate between major different economic systems

In this section, you'll learn about the basic organizing principles of different types of economies. Understanding the characteristics of a competitive market, in particular, is an important foundation for understanding the mechanisms of supply and demand, which you'll learn about later in this module.

Learning Objectives

- Distinguish between market, planned, and mixed economies

Economic Systems

Consider how complex a modern economy is. It includes all production of goods and services, all buying and selling, all employment. The economic life of every individual is interrelated, at least to a small extent, with the economic lives of thousands or even millions of other individuals. Who organizes and coordinates this system? Who insures that, for example, the number of televisions a society produces is the same as the amount it needs and wants? Who insures that the right number of employees works in the electronics industry? Who makes sure that televisions are produced in the best way possible? How does it all get done? The answer to these important questions depends on the kind of economic system a society uses.

On the right : Figure 2.3.1 Legoland, Billund, Denmark: Picture of a Planned Economy?

In the modern world today, there is a range of economic systems, from market economies to planned (or command) economies.

Market Economies

A **market** is any situation that brings together buyers and sellers of goods or services. Buyers and sellers can be either individuals or businesses. In a market economy, economic decision-making happens through markets. Market economies are based on private enterprise: the means of production (resources and businesses) are owned and operated by private individuals or groups of private individuals. Businesses supply goods and services based on demand. Which goods and services are supplied depends on what products businesses think will bring them the most profit. The more a product is demanded by consumers or other businesses, the higher the price businesses can charge, and so the more of the product will be supplied. Consumer demand depends on peoples' incomes. A person's income is based on his or her ownership of resources (especially labor). The more society values the person's output, the higher the income they will earn (think Lady Gaga or LeBron James).

Examples of free-market economies include Hong Kong, Singapore, and to a large extent, New Zealand, and the United States.

Free Markets

In a **market economy**, decisions about what products are available and at what prices are determined through the interaction of supply and demand. A **competitive market** is one in which there is a large number of buyers and sellers, so that no one can control the market price. A **free market** is one in which the government does not intervene in any way. A free and competitive market economy is the ideal type of market economy, because what is supplied is exactly what consumers demand.

Price controls are an example of a market that is not free. When government intervenes, the market outcomes will be different from those that would occur in a free and competitive market model. When markets are less than perfectly competitive (e.g., monopolistic), the market outcomes will also differ.

practice question 2.3.1

Which of the following is a defining feature of free markets?

a. There is a large number of buyers and sellers.
b. The government does not interfere in any way with the economic decisions of buyers and sellers
c. The means of production are owned by government, not private individuals.

Answer

b is correct - This is the key defining feature of free markets. The government allows the forces of supply and demand to determine quantity and price.

a is incorrect - This is not a necessary feature for a free market. A market in which a limited number of buyers or sellers control the market would still be a *free market* just not a *competitive market.*

c is incorrect - Private ownership of the means of production (labor, factories, businesses,etc.) is a defining feature of market economies and therefore free markets.

practice question 2.3.2

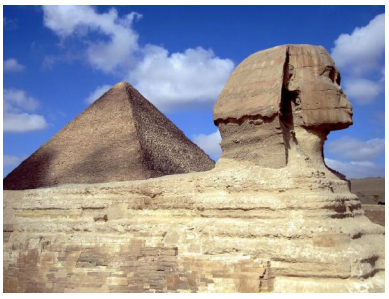
The economy of Atlantia is defined by the private ownership of the means of production by Atlantia's citizens. While owners are usually free to utilize their property as they see fit, the government does intervene to ban certain harmful products (i.e. addictive drugs, lead paint, etc) from entering the market. Atlantia's parliament has recently passed a minimum wage law setting minimum hourly compensation at $5.00 per hour. Atlantia is an example of a _____ economy.

a. mixed market
b. free market
c. command

Answer

a is correct - Private ownership of the means of production along with *limited government intervention* are characteristics of a market economy.

Planned (or Command) Economies



Command economies operate very differently. In a **command economy**, economic effort is devoted to goals passed down from a ruler or ruling class. Ancient Egypt was a good example: A large part of economic life was devoted to building pyramids (like the one at the left), for the pharaohs. Medieval manor life is another example: The lord provided the land for growing crops and protection in the event of war. In return, vassals provided labor and soldiers to do the lord's bidding. In the last century, communism emphasized command economies.

In a command economy, resources and businesses are owned by the government. The government decides what goods and services will be produced and what prices will be charged for them. The government decides what methods of production will be used and how much workers will be paid. Some necessities like health care and education are provided for free, as long as the state determines that you need them. Currently, North Korea and Cuba have command economies.

The primary distinction between a free and command economy is the degree to which the government determines what can be produced and what prices will be charged. In a free market, these determinations are made by the collective decisions of the market itself (which is comprised of producers and consumers). Producers and consumers make rational decisions about what will satisfy their self-interest and maximize profits, and the market responds accordingly. In a planned economy, the government makes most decisions about what will be produced and what the prices will be, and the market must follow that plan.

Most economies in the real world are mixed; they combine elements of command and market systems. The U.S. economy is positioned toward the market-oriented end of the spectrum. Many countries in Europe and Latin America, while primarily market-

oriented, have a greater degree of government involvement in economic decisions than in the U.S. economy. China and Russia, while they are closer now to having a market-oriented system than several decades ago, remain closer to the command-economy end of the spectrum.

practice question 2.3.3

Jane Doe is a shop owner in the fictional country of Xanadu. Every month the government's planning ministry sends her a large booklet (which resembles a phone book) regulating the price of essential commodities including milk, flour, and eggs. In response to these regulations Jane Doe has reduced her inventory of essential goods and switched to selling luxuries such as cakes, pies, and soft drinks. Luxury goods are not price controlled. Does Jane Doe reside in a command economy? Why or why not?

a. Jane resides in a command economy, as the government regulates some prices
b. Jane does not reside in a command economy. Prices and money have no real place in a real command economy.
c. Jane does not reside in a command economy. She owns her own business and is free to make *some* production and price decisions

Answer

c is correct - The government's extensive intervention in the economy combined with private ownership and limited independent market activity allows us to best characterize Xanadu's economy as 'mixed'.

a is incorrect - While Xanadu's government intervenes extensively in the economy, Jane's business is still privately owned and free to make some independent decisions. These are not features of a total command economy.

b is incorrect - While Jane does not reside in a command economy, lack of money is not a defining feature of command economies.

practice question 2.3.4

You are the leader of a revolutionary movement which has recently overthrown the government of the tiny country of Tropico. During the 3rd Party Congress, which was held shortly before your glorious victory, the party committee decreed that "to free Tropico's struggling masses from the jackboots of capitalism and reactionary imperialism, it is necessary to immediately enforce a command economy upon realization of our final victory." Which of the following actions would betray your mandate to create a command economy in Tropico?

a. Create a Ministry of Planning which will set prices, wages, and production targets.
b. Immediately expropriating all private property, which will now be state-owned
c. Maintain private ownership, but legalize labor unions which will now be free to bargain with private businesses for improved wages and benefits.

Answer

c is correct - This form of government intervention is limited and allows for the continued independence of privately owned businesses and resources. Their continued existence is a betrayal of the decrees issued during the 3rd Party Congress.

The following Crash Course video provides additional information about the broad economic choices that countries make when they decide between planned and market economies. The narrators talk fast, so you'll need to listen closely and possibly watch the video a second time!

To recap, economic systems determine the following:

- What to produce?
- How to produce it?
- Who gets it?

In a planned economy, government controls the factors of production:

- In a true communist economy, there is no private property—everyone owns the factors of production. This type of planned economy is called a command economy.
- In a socialist economy, there is some private property and some private control of industry.

In a free-market (capitalist) economy, individuals own the factors of production:

- Privately owned businesses produce products.
- Consumers choose the products they prefer causing the companies that product them to make more profit.

Even in free markets, governments will

- Maintain the rule of law
- Create public goods and services such as roads and education
- Step in when the market gets things wrong (e.g., setting minimum wage, establishing environmental standards)

In reality, economies are neither completely free-market nor completely planned. Neither exists in “pure” form, since all societies and governments regulate their economies to varying degrees. Throughout this course we will consider a number of ways in which the U.S. government influences and controls the economy.

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2.4: Demand

What you'll learn to do: explain the law of demand

Imagine that the price of Ben & Jerry's ice cream decreases by 25 percent during the next summer. What do you think will happen to the amount of Ben & Jerry's ice cream that people will want to buy? Clearly, the demand for ice cream will increase. By the same token, if the price of the ice cream were to rise by 25 percent, then the demand for the ice cream would fall. In this section, you will examine the law of demand and see why this simple concept is essential to understanding economics.

Learning Objectives

- Explain a demand curve
- Explain the factors that can change demand

The Law of Demand

Demand describes the amount of goods or services that consumers want to (and are able to) pay to purchase that good or service. Before learning more about the details of demand, watch this video to get a basic understanding about what it is and its importance to understanding economic behavior.

The law of demand states that, other things being equal,

- More of a good will be bought the lower its price
- Less of a good will be bought the higher its price

Ceteris paribus means "other things being equal."

Demand for Goods and Services

Economists use the term **demand** to refer to the amount of some good or service consumers are willing and able to purchase at each price. Demand is based on needs and wants—a consumer may be able to differentiate between a need and a want, but from an economist's perspective, they are the same thing. Demand is also based on ability to pay. If you can't pay for it, you have no effective demand.

What a buyer pays for a unit of the specific good or service is called the **price**. The total number of units purchased at that price is called the quantity **demanded**. A rise in the price of a good or service almost always decreases the quantity of that good or service demanded. Conversely, a fall in price will increase the quantity demanded. When the price of a gallon of gasoline goes up, for example, people look for ways to reduce their consumption by combining several errands, commuting by carpool or mass transit, or taking weekend or vacation trips closer to home. Economists call this inverse relationship between price and quantity demanded the **law of demand.** The law of demand assumes that all other variables that affect demand are held constant.

An example from the market for gasoline can be shown in the form of a table or a graph. (Refer back to "Reading: Creating and Interpreting Graphs" in module 0 if you need a refresher on graphs.) A table that shows the quantity demanded at each price, such as Table 1, is called a **demand schedule**. Price in this case is measured in dollars per gallon of gasoline. The quantity demanded is measured in millions of gallons over some time period (for example, per day or per year) and over some geographic area (like a state or a country).

Table 2.4.1. Price and Quantity Demanded of Gasoline

Price (per gallon)	Quantity Demanded (millions of gallons)
$1.00	800
$1.20	700
$1.40	600
$1.60	550
$1.80	500
$2.00	460
$2.20	420

A **demand curve** shows the relationship between price and quantity demanded on a graph like Figure 1, below, with quantity on the horizontal axis and the price per gallon on the vertical axis. *Note that this is an exception to the normal rule in mathematics that the independent variable (x) goes on the horizontal axis and the dependent variable (y) goes on the vertical. Economics is different from math!* Note also that each point on the demand curve comes from one row in Table 2.4.1. For example, the upper most point on the demand curve corresponds to the last row in Table 2.4.1, while the lower most point corresponds to the first row.

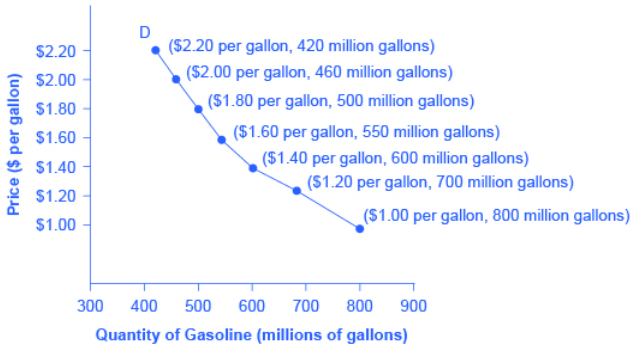


Figure $PageIndex1$. A Demand Curve for Gasoline (derived from the data in Table 2.4.1.

The demand schedule (Table 2.4.1 shows that as price rises, quantity demanded decreases, and vice versa. These points can then be graphed, and the line connecting them is the demand curve (shown by line D in the graph, above). The downward slope of the demand curve again illustrates the law of demand—the inverse relationship between prices and quantity demanded.

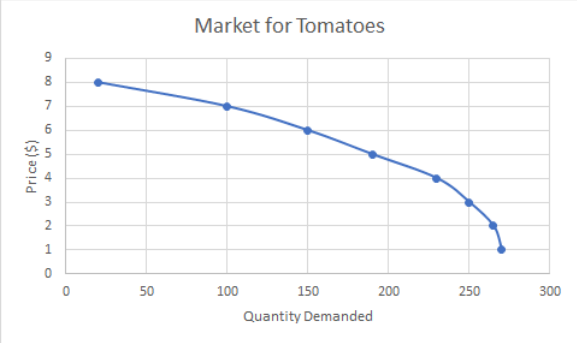
The demand schedule shown by Table 2.4.1 and the demand curve shown by the graph in Figure $|PageIndex1$ are two ways of describing the same relationship between price and quantity demanded.

Demand curves will look somewhat different for each product. They may appear relatively steep or flat, or they may be straight or curved. Nearly all demand curves share the fundamental similarity that they slope down from left to right. In this way, demand curves embody the law of demand: As the price increases, the quantity demanded decreases, and conversely, as the price decreases, the quantity demanded increases.

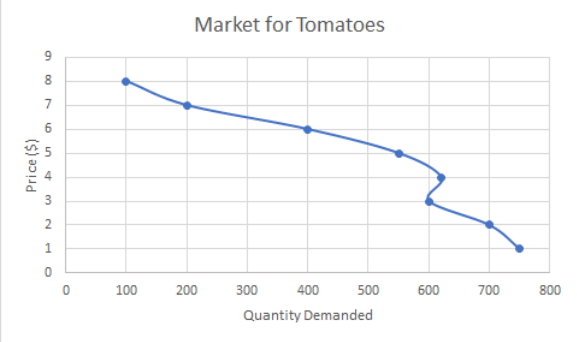
practice question 2.4.1

Which of the following demand curve for tomatoes violates the law of demand?

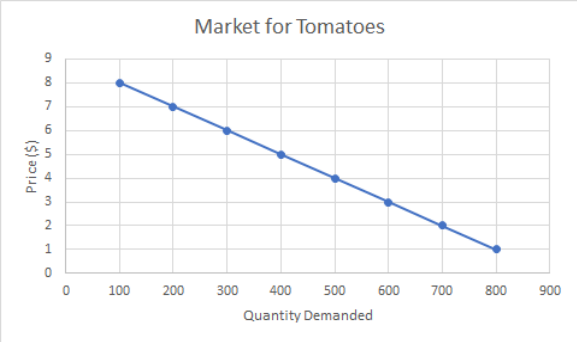
a.



b.



c.



Answer

b is the answer because as the price drops from $4 to $3 the quantity demanded is shown to fall, which is not consistent with the law of demand.

practice question 2.4.2

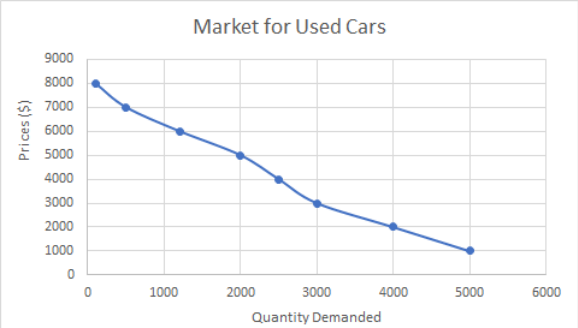
You are given the following demand schedule for used cars. Which of the following demand curves accurately represents this demand schedule and has proper formatting?

The demand schedule for used cars:

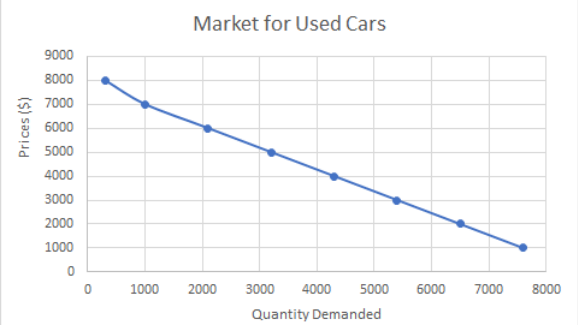
Price ($)	Quantity Demanded

1000	7600
2000	6500
3000	5400
4000	4300
5000	3200
6000	2100
7000	1000
8000	300

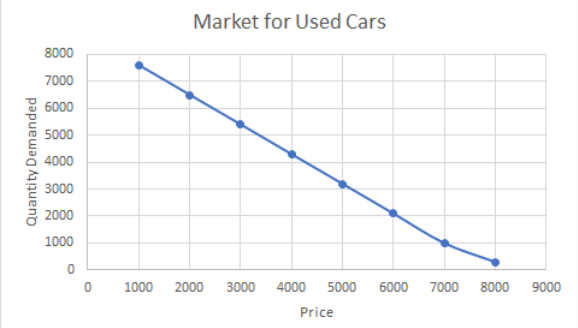
a.



b.



c.



Answer

b is correct - Price is displayed on the vertical axis, quantity on the horizontal, and all points are faithfully plotted according to the demand schedule.

demand vs. quantity demand

In economic terminology, *demand* is not the same as *quantity demanded*. When economists talk about demand, they mean the relationship between a range of prices and the quantities demanded at those prices, as illustrated by a demand curve or a demand schedule. When economists talk about quantity demanded, they mean only a certain point on the demand curve, or one quantity on the demand schedule. In short, demand refers to the curve and quantity demanded refers to the (specific) point on the curve.

Change in Demand vs. Change in Quantity Demanded

It's hard to overstate the importance of understanding the difference between shifts in curves and movements along curves. Remember, when we talk about changes in demand or supply, we do not mean the same thing as changes in *quantity demanded* or *quantity supplied*.

A change in **demand** refers to a shift in the entire demand curve, which is caused by a variety of factors (preferences, income, prices of substitutes and complements, expectations, population, etc.). In this case, the entire demand curve moves left or right.

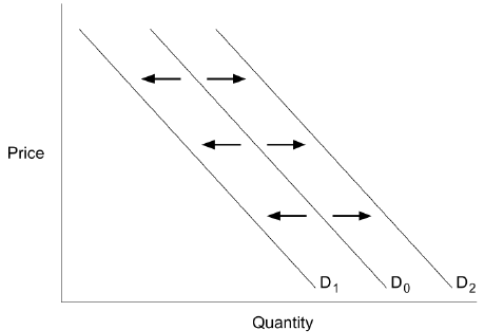


Figure 2.4.2. **Change in Demand**. A change in demand means that the entire demand curve shifts either left or right. The initial demand curve D_0 shifts to become either D_1 or D_2. This could be caused by a shift in tastes, changes in population, changes in income, prices of substitute or complement goods, or changes future expectations.

A change in **quantity demanded** refers to a movement along the demand curve, which is caused only by a chance in price. In this case, the demand curve doesn't move; rather, we move along the existing demand curve.

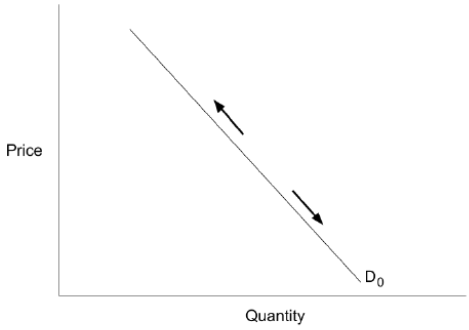
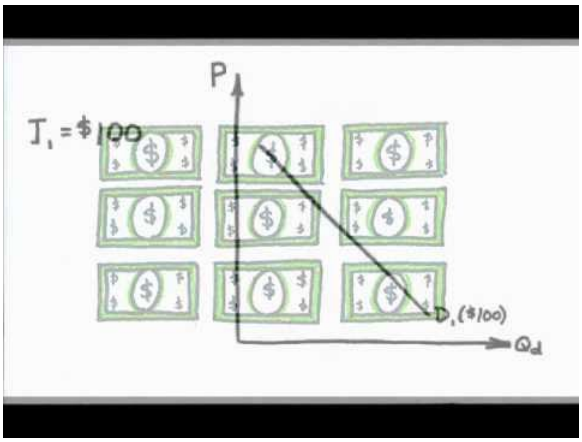


Figure 2.4.3. **Change in Quantity Demanded**. A change in the quantity demanded refers to movement along the existing demand curve, D_0. This is a change in price, which is caused by a shift in the supply curve.



Factors Affecting Demand

We defined demand as the amount of some product that a consumer is *willing* and *able* to purchase at each *price*. This suggests at least two factors, in addition to price, that affect demand. "Willingness to purchase" suggests a desire to buy, and it depends on what economists call tastes and preferences. If you neither need nor want something, you won't be willing to buy it. "Ability to purchase" suggests that income is important. Professors are usually able to afford better housing and transportation than students, because they have more income. The prices of related goods can also affect demand. If you need a new car, for example, the price of a Honda may affect your demand for a Ford. Finally, the size or composition of the population can affect demand. The more children a family has, the greater their demand for clothing. The more driving-age children a family has, the greater their demand for car insurance and the less for diapers and baby formula.

These factors matter both for demand by an individual and demand by the market as a whole. Exactly how do these various factors affect demand, and how do we show the effects graphically? To answer those questions, we need the *ceteris paribus* assumption.

The *Ceteris Paribus* Assumption

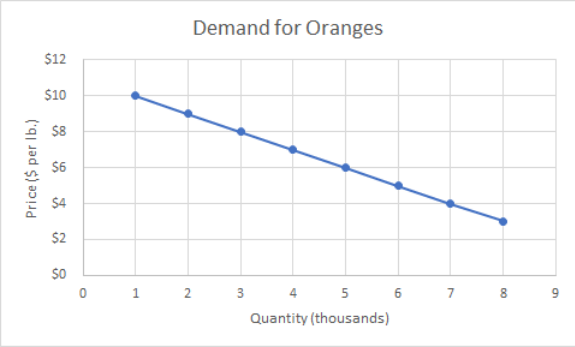
A *demand curve* or a *supply curve* (which we'll cover later in this module) is a relationship between two, and only two, variables: quantity on the horizontal axis and price on the vertical axis. The assumption behind a demand curve or a supply curve is that no relevant economic factors, other than the product's price, are changing. Economists call this assumption ***ceteris paribus***, a Latin phrase meaning "other things being equal." Any given demand or supply curve is based on the *ceteris paribus* assumption that all else is held equal. (You'll recall that economists use the *ceteris paribus* assumption to simplify the focus of analysis.) Therefore, a demand curve or a supply curve is a relationship between two, and only two, variables *when all other variables are held equal*. If all else is not held equal, then the laws of supply and demand will not necessarily hold.

Ceteris paribus is typically applied when we look at how changes in price affect demand or supply, but *ceteris paribus* can also be applied more generally. In the real world, demand and supply depend on more factors than just price. For example, a consumer's demand depends on income, and a producer's supply depends on the cost of producing the product. How can we analyze the effect on demand or supply if multiple factors are changing at the same time—say price rises and income falls? The answer is that we examine the changes one at a time, and assume that the other factors are held constant.

For example, we can say that an increase in the price reduces the amount consumers will buy (assuming income, and anything else that affects demand, is unchanged). Additionally, a decrease in income reduces the amount consumers can afford to buy (assuming price, and anything else that affects demand, is unchanged). This is what the *ceteris paribus* assumption really means. In this particular case, after we analyze each factor separately, we can combine the results. The amount consumers buy falls for two reasons: first because of the higher price and second because of the lower income.

practice question 2.4.3

Below is the demand curve for oranges in a Florida supermarket. Select the demand schedule that best corresponds to this demand curve.



a.

Demand Schedule for Oranges	
Quantity (thousands)	Price (per pound)
8	$10
7	$9
6	$8
5	$7
4	$6
3	$5
2	$4
1	$3

b.

Demand Schedule for Oranges	
Quantity (thousands)	Price (per pound)
1	$20
2	$18
3	$16
4	$14
5	$12
6	$10
7	$8
8	$6

c.

Demand Schedule for Oranges

Quantity (thousands)	Price (per pound)
1	$10
2	$9
3	$8
4	$7
5	$6
6	$5
7	$4
8	$3

Answer

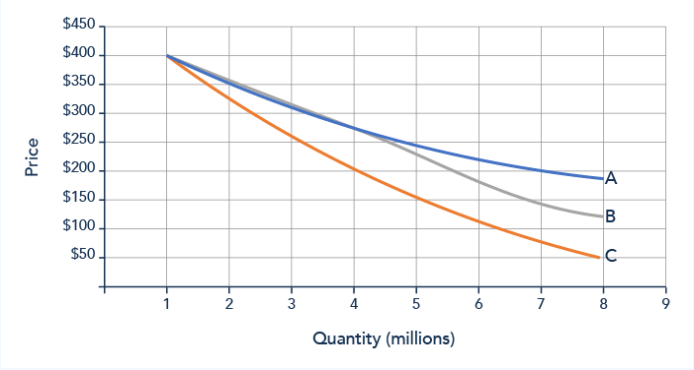
C.

practice question 2.4.4

You are the chief data analyst of the U.S. Fish and Wildlife Service for the Northeast region. Recently the agency has become concerned about overfishing in the North Atlantic fisheries, and you are charged with estimating the demand curve for tuna as part of the agency's mitigation efforts.

From public surveys you know that when the price of a freshly caught tuna is $400, the public will demand a quantity of 1 million fish. If the price is $275 then the public will demand 4 million fish. Finally, if the price was $185 consumers will demand a quantity of 8 million fish.

Which curve below could be the correct demand curve for North Atlantic tuna given these three data points?



a. the blue curve
b. the silver curve
c. the orange curve

Answer

A is correct - only the blue curve passes through all three data points given

The Effect of Income on Demand

Let's use income as an example of how factors other than price affect demand. Figure 4 shows the initial demand for automobiles as D0. At point Q, for example, if the price is $20,000 per car, the quantity of cars demanded is 18 million. D0 also shows how the quantity of cars demanded would change as a result of a higher or lower price. For example, if the price of a car rose to $22,000, the quantity demanded would decrease to 17 million, at point R.

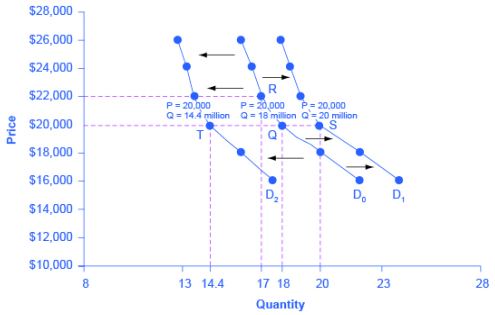


Figure 2.4.4. **Shifts in Demand: A Car Example**

The original demand curve D0, like every demand curve, is based on the ceteris paribus assumption that no other economically relevant factors change. Now imagine that the economy expands in a way that raises the incomes of many people, making cars more affordable. How will this affect demand? How can we show this graphically?

Return to Figure 2.4.1. The price of cars is still $20,000, but with higher incomes, the quantity demanded has now increased to 20 million cars, shown at point S. As a result of the higher income levels, the demand curve shifts to the right to the new demand curve D1, indicating an increase in demand. Table 2.4.1, below, shows clearly that this increased demand would occur at every price, not just the original one.

Table 2.4.1. Price and Demand Shifts: A Car Example

Price	Decrease to D_2	Original Quantity Demanded D_0	Increase to D_1
$16,000	17.6 million	22.0 million	24.0 million
$18,000	16.0 million	20.0 million	22.0 million
$20,000	14.4 million	18.0 million	20.0 million
$22,000	13.6 million	17.0 million	19.0 million
$24,000	13.2 million	16.5 million	18.5 million
$26,000	12.8 million	16.0 million	18.0 million

Now, imagine that the economy slows down so that many people lose their jobs or work fewer hours, reducing their incomes. In this case, the decrease in income would lead to a lower quantity of cars demanded at every given price, and the original demand curve D_0 would shift left to D_2. The shift from D_0 to D_2 represents such a decrease in demand: At any given price level, the quantity demanded is now lower. In this example, a price of $20,000 means 18 million cars sold along the original demand curve, but only 14.4 million sold after demand fell.

When a demand curve shifts, it does not mean that the quantity demanded by every individual buyer changes by the same amount. In this example, not everyone would have higher or lower income and not everyone would buy or not buy an additional car. Instead, a shift in a demand curve captures a pattern for the market as a whole: Increased demand means that at every given price, the quantity demanded is higher, so that the demand curve shifts to the right from D_0 to D_1. And, decreased demand means that at every given price, the quantity demanded is lower, so that the demand curve shifts to the left from D_0 to D_2.

We just argued that higher income causes greater demand at every price. This is true for most goods and services. For some—luxury cars, vacations in Europe, and fine jewelry—the effect of a rise in income can be especially pronounced. A product whose demand rises when income rises, and vice versa, is called a **normal good**. A few exceptions to this pattern do exist, however. As incomes rise, many people will buy fewer generic-brand groceries and more name-brand groceries. They are less likely to buy used cars and more likely to buy new cars. They will be less likely to rent an apartment and more likely to own a home, and so on. A product whose demand falls when income rises, and vice versa, is called an **inferior good**. In other words, when income increases, the demand curve shifts to the left.

practice question 2.4.5

Alexis owns a small business selling power tools. This past month she has noticed that the quantity demanded for high-end electric drills has decreased by 25%. Which of the following demand curve **shifting** events is a possible explanation for this change?

a. The price of electric drills has increased.
b. Customers' incomes have decreased.
c. Customers' incomes have increased.

Answer

b is correct - Falling incomes would lead to a leftward shift of the demand curve causing less quantity demanded at any given price.

a is incorrect - While this would explain the decrease in quantity demanded, it will not have occurred because of a shift in the demand curve, rather movement along the existing curve.

c is incorrect - This would cause an increase in quantity demanded at any given price level rather than a decrease.

practice question 2.4.6

Over the past century the quantity of potatoes purchased by Irish consumers has fallen significantly, while incomes have grown exponentially. Meanwhile potatoes are still the cheapest source of calories available to the consumer. From this information it would be correct to assume that potatoes are a(n) _____ good.

a. essential
b. normal
c. inferior

Answer

c is correct - An inverse relationship between demand and incomes in the hallmark of an inferior good.

a is incorrect - Whether a good is 'essential' or not has no bearing on the evidence presented.

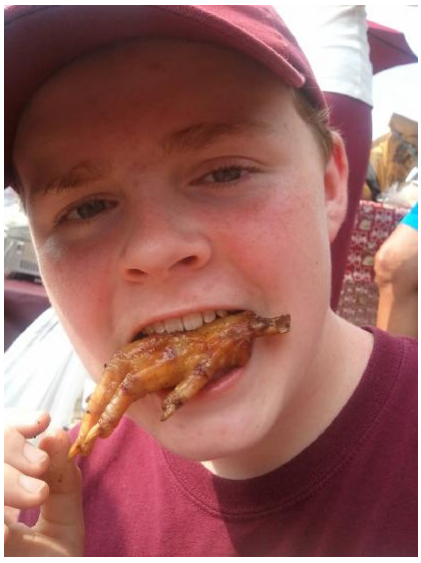
b is incorrect - We would expect to see demand increases as incomes rose if potatoes are a normal good.

Other Factors That Shift Demand Curves

Income is not the only factor that causes a shift in demand. Other things that change demand include tastes and preferences, the composition or size of the population, the prices of related goods, and even expectations. A change in any one of the underlying factors that determine what quantity people are willing to buy at a given price will cause a shift in demand. Graphically, the new demand curve lies either to the right (an increase) or to the left (a decrease) of the original demand curve. Let’s look at these factors.

Changing Tastes or Preferences

From 1980 to 2012, the per-person consumption of chicken by Americans rose from 33 pounds per year to 81 pounds per year, and consumption of beef fell from 77 pounds per year to 57 pounds per year, according to the U.S. Department of Agriculture (USDA). Changes like these are largely due to shifts in taste, which change the quantity of a good demanded at every price: That is, they shift the demand curve for that good—rightward for chicken and leftward for beef.



Changes in the Composition of the Population

The proportion of elderly citizens in the United States population is rising. It rose from 9.8 percent in 1970 to 12.6 percent in 2000 and will be a projected (by the U.S. Census Bureau) 20 percent of the population by 2030. A society with relatively more children, like the United States in the 1960s, will have greater demand for goods and services like tricycles and day care facilities. A society with relatively more elderly persons, as the United States is projected to have by 2030, has a higher demand for nursing homes and hearing aids. Similarly, changes in the size of the population can affect the demand for housing and many other goods. Each of these changes in demand will be shown as a shift in the demand curve.

Changes in the Prices of Related Goods

The demand for a product can also be affected by changes in the prices of related goods such as substitutes or complements. A **substitute** is a good or service that can be used in place of another good or service. As electronic books, like this one, become more available, you would expect to see a decrease in demand for traditional printed books. A lower price for a substitute decreases demand for the other product. For example, in recent years as the price of tablet computers has fallen, the quantity demanded has increased (because of the law of demand). Since people are purchasing tablets, there has been a decrease in demand for laptops, which can be shown graphically as a leftward shift in the demand curve for laptops. A higher price for a substitute good has the reverse effect.

Other goods are **complements** for each other, meaning that the goods are often used together, because consumption of one good tends to enhance consumption of the other. Examples include breakfast cereal and milk; notebooks and pens or pencils, golf balls and golf clubs; gasoline and sport utility vehicles; and the five-way combination of bacon, lettuce, tomato, mayonnaise, and bread. If the price of golf clubs rises, since the quantity of golf clubs demanded falls (because of the law of demand), demand for a complement good like golf balls decreases, too. Similarly, a higher price for skis would shift the demand curve for a complement good like ski resort trips to the left, while a lower price for a complement has the reverse effect.

Changes in Expectations About Future Prices or Other Factors That Affect Demand

While it is clear that the price of a good affects the quantity demanded, it is also true that expectations about the future price (or expectations about tastes and preferences, income, and so on) can affect demand. For example, if people hear that a hurricane is coming, they may rush to the store to buy flashlight batteries and bottled water. If people learn that the price of a good like coffee is likely to rise in the future, they may head for the store to stock up on coffee now. These changes in demand are shown as shifts in the curve. Therefore, a **shift in demand** happens when a change in some economic factor (other than the current price) causes a different quantity to be demanded at every price.

practice question 2.4.7

Natalie runs a fast food stand selling hot dogs and soft drinks. A decrease in the price of which good below is likely to negatively impact her bottom line?

a. hamburgers
b. t-shirts
c. mustard

Answer

a is correct - Hamburgers and hot dogs are likely to be substitutes, so if the price of hamburgers falls this will likely shift the demand curve for hot dogs to the left, decreasing her sales of hot dogs.

practice question 2.4.8

Over the past 10 years consumer incomes have grown by 15%, while the price of automobiles has increased by over 20%. Tires and automobiles are complement goods. What would be a reasonable expectation regarding the demand for tires today compared to 10 years ago?

a. The demand for tires will shift to the left because the price of the complement good-automobiles-has increased
b. The demand for tires will shift to the right because of the income effect.
c. It is impossible to know with the given information

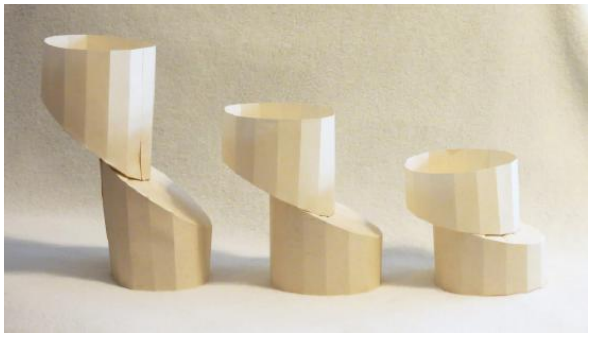
Answer

c is correct - The income effect will increase demand for tires, while the increase in the price of automobiles will decrease demand. It is impossible to know at the present time which effect is strong.

a is incorrect - While increasing the price of a complement good would decrease demand for tires, the impact of income on tires and automobiles must also be considered.

b is incorrect - While the income effect is likely to increase demand for automobiles and therefore tires, the effect of a price increase for the complement good automobiles must also be considered.

Summary



Six factors that can shift demand curves are summarized in Figure 2.4.5, below. The direction of the arrows indicates whether the demand curve shifts represent an increase in demand or a decrease in demand. Notice that a change in the price of the good or service itself is not listed among the factors that can shift a demand curve. A change in the price of a good or service causes a movement along a specific demand curve, and it typically leads to some change in the quantity demanded, but it does not shift the demand curve.

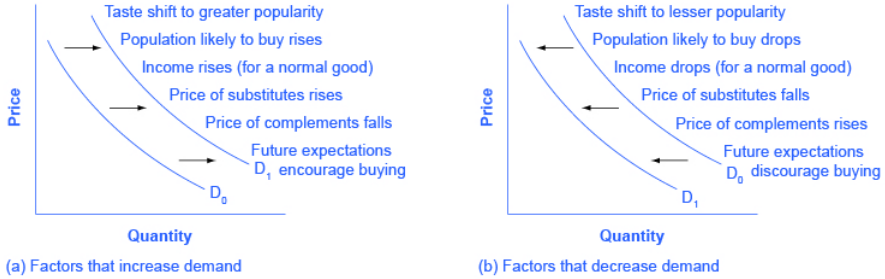
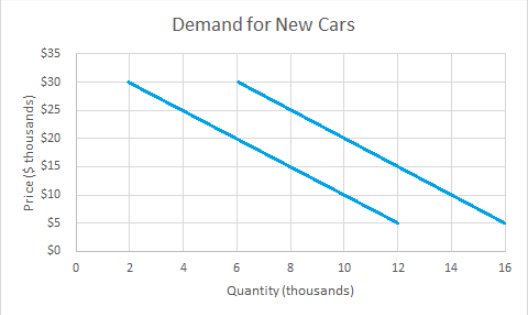


Figure 2.4.5. Factors That Shift Demand Curves (a) A list of factors that can cause an increase in demand from D_0 to D_1. (b) The same factors, if their direction is reversed, can cause a decrease in demand from D_0 to D_1.

practice question 2.4.9

You are a consultant analyzing the American car market for the new Toyota Prius. Your chief competitor Tesla has recently dropped the list price of their vehicles by 20%. When illustrating shifts of the demand curve it is customary to draw arrows to show the direction of change. Which directions should the arrows be drawn in the graph below? Which curve represents old demand and which curve the new demand?



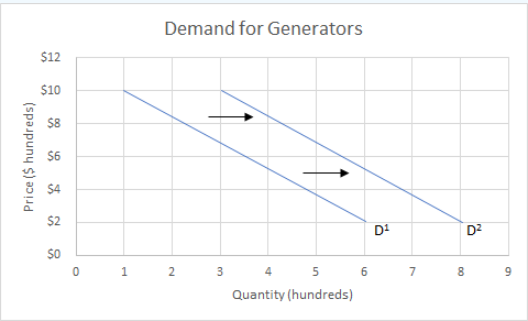
a. The arrows should be drawn pointing leftwards. The curve on the right represents the new demand and the curve on the left old demand.
b. The arrows should be drawn pointing rightwards. The curve on the right represents new demand and the curve on the left old demand.
c. The arrows should be drawn pointing leftwards. The curve on the right represents the old demand and the curve on the left new demand.

Answer

C

practice question 2.4.10

You are in charge of data analytics for Home Depot's South Florida division. Recently you have observed a change in the market for power generators illustrated below. Which explanation best corresponds with the observed data?



a. The price of a competitor's generators has fallen.
b. The price of Home Depot generators has dropped 20%.
c. A hurricane is expected to arrive next week.

Answer

c is correct - Expectations of an impending storm are likely to increase short-run demand, which is consistent with what we observe in the demand curves here.

a is incorrect - A drop in the price of substituted goods will cause a leftward shift of the demand curve.

b is incorrect - A price change would cause a movement along the demand curve, not a shift in demand. Step 2. Suppose income increases. As a result of the change, are consumers going to buy more or less pizza? The answer is more. Draw a dotted horizontal line from the chosen price, through the original quantity demanded, to the new point with the new Q1. Draw a dotted vertical line down to the horizontal axis and label the new Q1. An example is provided in Figure 6.

Shift in demand due to income increase

A shift in demand means that at any price (and at every price), the quantity demanded will be different than it was before. Following is a graphic illustration of a shift in demand due to an income increase.

Step 1. Draw the graph of a demand curve for a normal good like pizza. Pick a price (like P_0). Identify the corresponding Q_0. An example is shown in Figure 2.4.6.

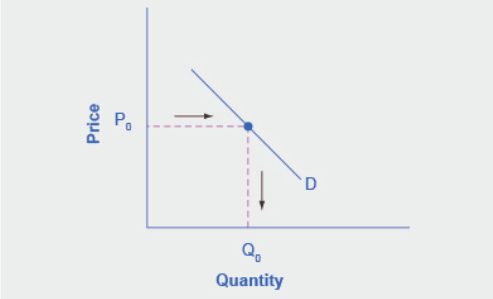


Figure 2.4.6. Demand Curve. A demand curve can be used to identify how much consumers would buy at any given price.

Step 2. Suppose income increases. As a result of the change, are consumers going to buy more or less pizza? The answer is more. Draw a dotted horizontal line from the chosen price, through the original quantity demanded, to the new point with the new Q_1. Draw a dotted vertical line down to the horizontal axis and label the new Q_1. An example is provided in Figure 2.4.7.

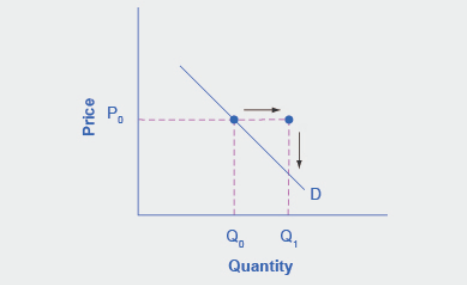


Figure 2.4.7. Demand Curve with Income Increase. With an increase in income, consumers will purchase larger quantities, pushing demand to the right.

Step 3. Now, shift the curve through the new point. You will see that an increase in income causes an upward (or rightward) shift in the demand curve, so that at any price, the quantities demanded will be higher, as shown in Figure 2.4.8.

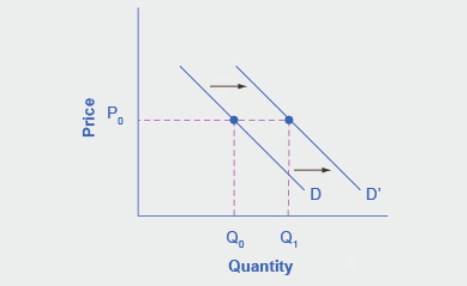
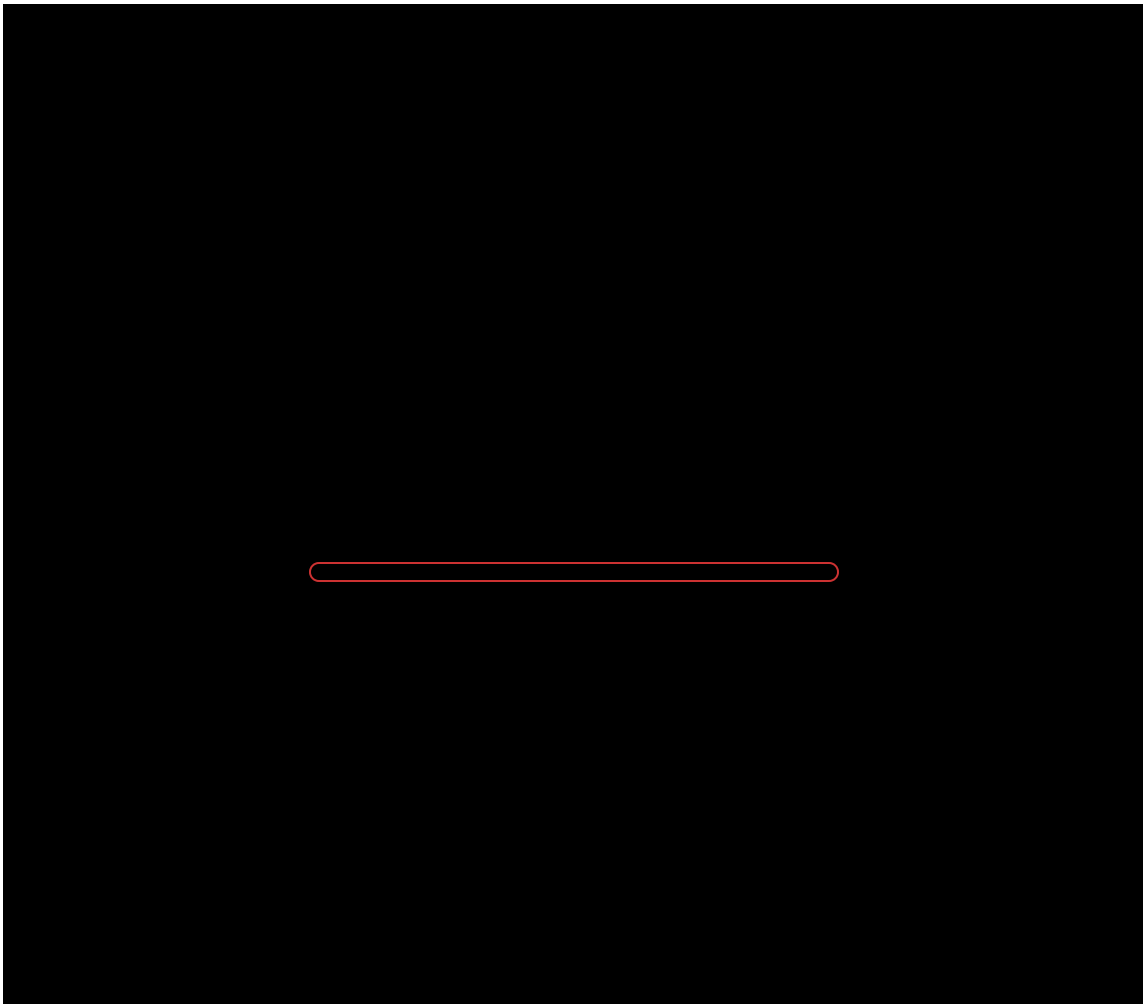


Figure 2.4.8. Demand Curve Shifted Right. With an increase in income, consumers will purchase larger quantities, pushing demand to the right, and causing the demand curve to shift right.

Simulation: Demand for Food Trucks

Play the simulation below multiple times to see how different choices lead to different outcomes. All simulations allow unlimited attempts so that you can gain experience applying the concepts.



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2.5: Supply

What you'll learn to do: explain the law of supply

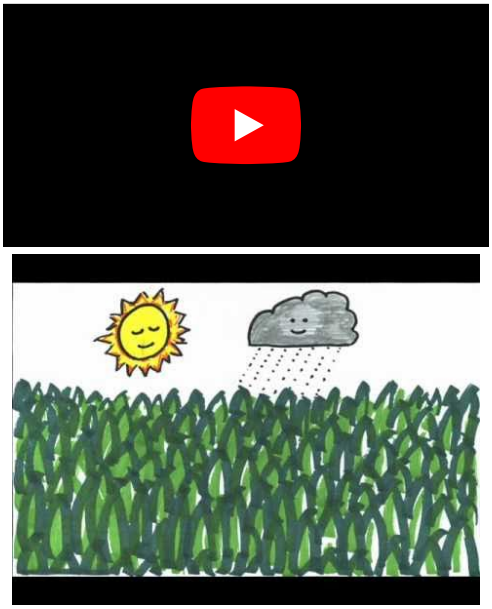
So far you've learned about the role of demand in economics—which is the consumer side of the story. In this section, you'll learn about the producer side of economics to see what factors impact the amount of goods supplied in a market. For example, suppose the global price of petroleum falls significantly. What do you think will happen to the supply of gasoline? How are supply and price connected? In the following readings you'll examine the law of supply and see why this counterpart to "demand" is also essential to understanding economics.

Learning Objectives

- Explain a supply curve
- Explain the factors that can change supply

The Law of Supply

The law of supply states that more of a good will be provided the higher its price; less will be provided the lower its price, *ceteris paribus*. There is a direct relationship between price and quantity supplied. Watch this video to learn more.



Supply of Goods and Services

When economists talk about **supply**, they mean the amount of some good or service a producer is willing to supply at each price. Price is what the producer receives for selling one unit of a good or service. A rise in price almost always leads to an increase in the quantity supplied of that good or service, while a fall in price will decrease the quantity supplied. When the price of gasoline rises, for example, it encourages profit-seeking firms to take several actions: expand exploration for oil reserves; drill for more oil; invest in more pipelines and oil tankers to bring the oil to plants where it can be refined into gasoline; build new oil refineries; purchase additional pipelines and trucks to ship the gasoline to gas stations; and open more gas stations or keep existing gas stations open longer hours. Economists call this positive relationship between price and quantity supplied—that a higher price leads to a higher quantity supplied and a lower price leads to a lower quantity supplied—the **law of supply**. The law of supply, like the law of demand, assumes that all other variables that affect supply (to be explained in the next reading) are held equal.

supply vs. quantity supplied

In economic terminology, supply is not the same as quantity supplied. When economists refer to supply, they mean the relationship between a range of prices and the quantities supplied at those prices, a relationship that can be illustrated with a supply curve or a supply schedule. When economists refer to **quantity supplied**, they mean only a certain point on the supply curve, or one quantity on the supply schedule. In short, supply refers to the curve, and quantity supplied refers to the (specific) point on the curve.

Figure 2.5.1, below, illustrates the law of supply, again using the market for gasoline as an example. Like demand, supply can be illustrated using a table or a graph. A **supply schedule** is a table—like Table 2.5.1, below—that shows the quantity supplied at a range of different prices. Again, price is measured in dollars per gallon of gasoline, and quantity demanded is measured in millions of gallons. **A supply curve** is a graphic illustration of the relationship between price, shown

on the vertical axis, and quantity, shown on the horizontal axis. You can see from this curve (Figure 2.5.1) that as the price rises, quantity supplied also increases and vice versa. The supply schedule and the supply curve are just two different ways of showing the same information. Notice that the horizontal and vertical axes on the graph for the supply curve are the same as for the demand curve.

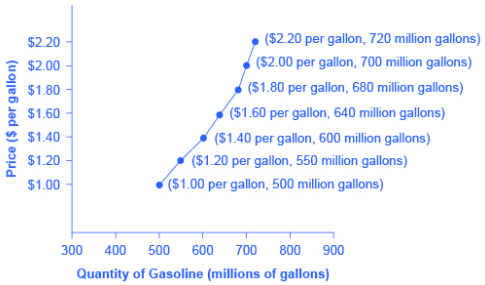


Figure 2.5.1. A Supply Curve for Gasoline

Table 2.5.1. Price and Supply of Gasoline

Price (per gallon)	Quantity Supplied (millions of gallons)
$1.00	500
$1.20	550
$1.40	600
$1.60	640
$1.80	680
$2.00	700
$2.20	720

The shape of supply curves will vary somewhat according to the product: steeper, flatter, straighter, or curved. Nearly all supply curves, however, share a basic similarity: They slope up from left to right and illustrate the law of supply. As the price rises, say, from $1.00 per gallon to $2.20 per gallon, the quantity supplied increases from 500 gallons to 720 gallons. Conversely, as the price falls, the quantity supplied decreases.

practice question 2.5.1

Michael is the owner of a steel refinery in Pittsburgh, PA. In October the price for a ton of steel was $400, which increased to $600 by November. According to the *law of supply*, what would be a rational response by Michael to this change in market price for steel?

a. Shut down 2 out of the 4 smelters at his steel plant.
b. Hire additional workers.
c. Layoff workers and reduce output.

Answer

b. The law of supply postulates a positive relationship between quantity supplied and price. If price increases, so must steel output.

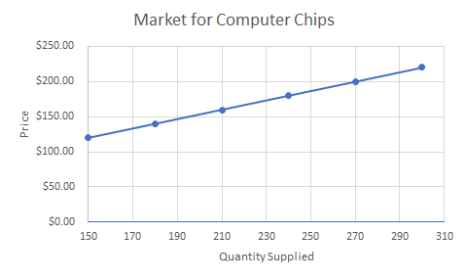
practice question 2.5.2

Joshua operates a small information technology business which supplies advanced microchips to local businesses. His supply schedule for microchips is displayed below. Which supply curve shown more accurately reflects his supply schedule?

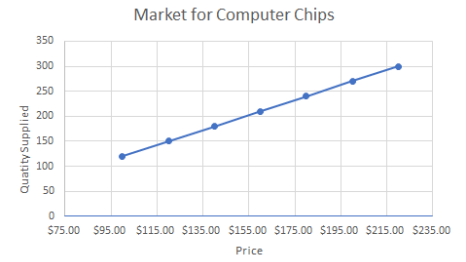
Price and Supply of Computer Chips

Price	Quantity Supplied
$100.00	120
$120.00	150
$140.00	180
$160.00	210
$180.00	240
$200.00	270
$220.00	300

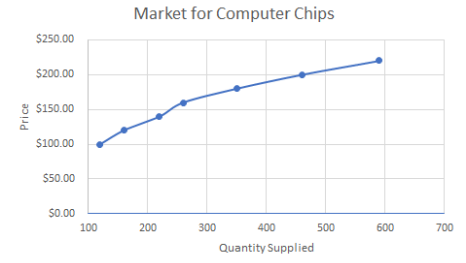
a.



b.



c.



Answer

a.

Factors Affecting Supply

How Production Costs Affect Supply

A supply curve shows how quantity supplied will change as the price rises and falls, assuming *ceteris paribus*, so that no other economically relevant factors are changing. If other factors relevant to supply do change, then the entire supply curve will shift. Just as a shift in demand is represented by a change in the quantity demanded at every price, a **shift in supply** means a change in the quantity supplied at every price.

In thinking about the factors that affect supply, remember what motivates firms: profits, which are the difference between revenues and costs. Goods and services are produced using combinations of labor, materials, and machinery, or what we call **inputs** (also called **factors of production**). If a firm faces lower costs of production, while the prices for the good or service the firm produces remain unchanged, a firm's profits go up. When a firm's profits increase, it's more motivated to produce **output** (goods or services), since the more it produces the more profit it will earn. So, when costs of production fall, a firm will tend to supply a larger quantity at any given price for its output. This can be shown by the supply curve shifting to the right.

Take, for example, a messenger company that delivers packages around a city. The company may find that buying gasoline is one of its main costs. If the price of gasoline falls, then the company will find it can deliver packages more cheaply than before. Since lower costs correspond to higher profits, the messenger company may now supply more of its services at any given price. For example, given the lower gasoline prices, the company can now serve a greater area, and increase its supply.

Conversely, if a firm faces higher costs of production, then it will earn lower profits at any given selling price for its products. As a result, a higher cost of production typically causes a firm to supply a smaller quantity at any given price. In this case, the supply curve shifts to the left.

Consider the supply for cars, shown by curve S_0 in Figure 2.5.2, below. Point J indicates that if the price is $20,000, the quantity supplied will be 18 million cars. If the price rises to $22,000 per car, *ceteris paribus*, the quantity supplied will rise to 20 million cars, as point K on the S_0 curve shows. The same information can be shown in table form, as in Table 2.5.1.

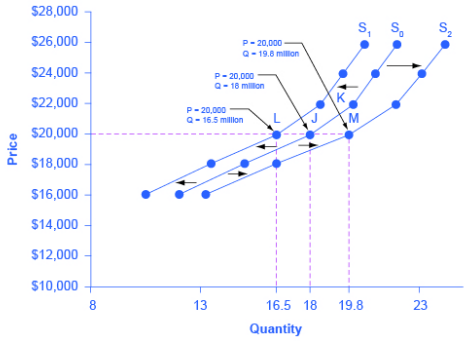


Figure 2.5.2. Shifts in Supply: A Car Example

Table 2.5.1. Price and Shifts in Supply: A Car Example

Price	Decrease to S_1	Original Quantity Supplied S_0	Increase to S_2
$16,000	10.5 million	12.0 million	13.2 million
$18,000	13.5 million	15.0 million	16.5 million
$20,000	16.5 million	18.0 million	19.8 million
$22,000	18.5 million	20.0 million	22.0 million
$24,000	19.5 million	21.0 million	23.1 million

Now imagine that the price of steel—an important component in vehicle manufacturing—rises, so that producing a car has become more expensive. At any given price for selling cars, car manufacturers will react by supplying a lower quantity. This can be shown graphically as a leftward shift of supply, from S_0 to S_1, which indicates that at any given price, the quantity supplied decreases. In this example, at a price of $20,000, the quantity supplied decreases from 18 million on the original supply curve (S_0) to 16.5 million on the supply curve S_1, which is labeled as point L.

Conversely, if the price of steel decreases, producing a car becomes less expensive. At any given price for selling cars, car manufacturers can now expect to earn higher profits, so they will supply a higher quantity. The shift of supply to the right, from S_0 to S_2, means that at all prices, the quantity supplied has increased. In this example, at a price of $20,000, the quantity supplied increases from 18 million on the original supply curve (S_0) to 19.8 million on the supply curve S_2, which is labeled M.

Other Factors That Affect Supply

In the example above, we saw that changes in the prices of inputs in the production process will affect the cost of production and thus the supply. Several other things affect the cost of production, too, such as changes in weather or other natural conditions, new technologies for production, and some government policies.

The cost of production for many agricultural products will be affected by changes in natural conditions. For example, the area of northern China that typically grows about 60 percent of the country's wheat output experienced its worst drought in at least fifty years in the second half of 2009. A drought decreases the supply of agricultural products, which means that at any given price, a lower quantity will be supplied; conversely, especially good weather would shift the supply curve to the right.

When a firm discovers a new technology that allows it to produce at a lower cost, the supply curve will shift to the right, as well. For instance, in the 1960s a major scientific effort nicknamed the Green Revolution focused on breeding improved seeds for basic crops like wheat and rice. By the early 1990s, more than two-thirds of the wheat and rice in low-income countries around the world was grown with these Green Revolution seeds—and the harvest was twice as high per acre. A technological improvement that reduces costs of production will shift supply to the right, so that a greater quantity will be produced at any given price.

Government policies can affect the cost of production and the supply curve through taxes, regulations, and subsidies. For example, the U.S. government imposes a tax on alcoholic beverages that collects about $8 billion per year from producers. Taxes are treated as costs by businesses. Higher costs decrease supply for the reasons discussed above. Other examples of policy that can affect cost are the wide array of government regulations that require firms to spend money to provide a cleaner environment or a safer workplace; complying with regulations increases costs.

A government subsidy, on the other hand, is the opposite of a tax. A **subsidy** occurs when the government pays a firm directly or reduces the firm's taxes if the firm carries out certain actions. From the firm's perspective, taxes or regulations are an additional cost of production that shifts supply to the left, leading the firm to produce a lower quantity at every given price. Government subsidies reduce the cost of production and increase supply at every given price, shifting supply to the right.

practice question 2.5.3

As an economist at the USDA you observe there has been a change in the market for processed corn this past year (displayed below). Which option below can best explain this recent market shift?

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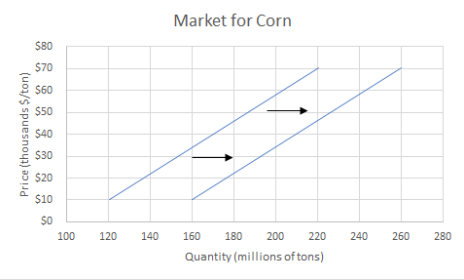


a. There has been an exceptionally short growing season this past year.
b. The cost of farm labor has decreased
c. The price of wheat, a substitute, has increased

Answer

b is correct - Lower input costs are one factor that can shift the supply curve rightwards.

a is incorrect - Unfavorable natural conditions are likely to shift the demand curve leftwards, not rightwards.

c is incorrect - Higher substitute cost will shift the demand curve rightwards, not the supply curve.

Exercise 2.5.4

Several unfavorable changes have occurred this past year for almond suppliers in California. A drought continues to ravage crops, and a recent strike by migrant farm laborers has sent production costs soaring. In response to these recent events the almond growers lobby has successfully petitioned the California state legislator for a significant subsidy to almond farmers.

Given these events, how would we expect the supply curve for almonds to react?

a. The supply curve would shift inwards
b. The supply curve would shift outwards
c. It is impossible to tell with the given information

Answer

C - A subsidy should shift supply rightwards, while the drought and labor strike has the opposite effect. We have no way of knowing which is stronger.

Summary

Changes in the cost of inputs, natural disasters, new technologies, and the impact of government decisions all affect the cost of production. In turn, these factors affect how much firms are willing to supply at any given price.

Figure $|PageIndex3$, below, summarizes factors that change the supply of goods and services. Notice that a change in the price of the product itself is not among the factors that shift the supply curve. Although a change in price of a good or service typically causes a change in quantity supplied or a movement along the supply curve for that specific good or service, it does not cause the supply curve itself to shift.

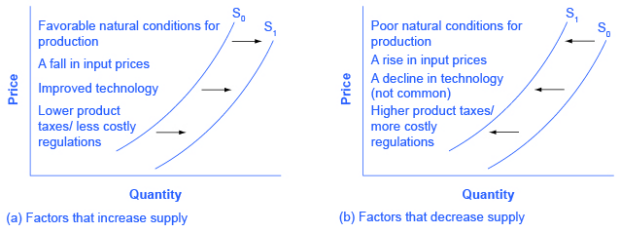


Figure 2.5.3. **Factors That Shift Supply Curves.** (a) A list of factors that can cause an increase in supply from S_0 to S_1. (b) The same factors, if their direction is reversed, can cause a decrease in supply from S_0 to S_1.

Because demand and supply curves appear on a two-dimensional diagram with only price and quantity on the axes, an unwary visitor to the land of economics might be fooled into believing that economics is about only four topics: demand, supply, price, and quantity. However, demand and supply are really "umbrella" concepts: demand covers all the factors that affect demand, and supply covers all the factors that affect supply. Factors other than price that affect demand and supply are included by using shifts in the demand or the supply curve. In this way, the two-dimensional demand and supply model becomes a powerful tool for analyzing a wide range of economic circumstances.

Exercise 2.5.5

List and explain three out of the four factors responsible for shifts in the supply curve.

Answer

The four factors that can shift the supply curve include natural conditions, input prices, technology, and government. Natural conditions include any natural event that may favorably or unfavorably impact production. Lower input costs will increase the profit margin of the supplier, encouraging them to provide more output at any given price. Improved technology can increase what a supplier can produce with a given set of inputs. Government intervention can either encourage or discourage production depending on the type of intervention (subsidy vs. tax, regulation vs. deregulation, etc).

worked example: Shift in supply due to production-cost increase

We know that a supply curve shows the minimum price a firm will accept to produce a given quantity of output. What happens to the supply curve when the cost of production goes up? Following is an example of a shift in supply due to an increase in production cost.

Step 1. Draw a graph of a supply curve for pizza. Pick a quantity (like Q_0). If you draw a vertical line up from Q_0 to the supply curve, you will see the price the firm chooses. An example is shown in Figure 2.5.4.

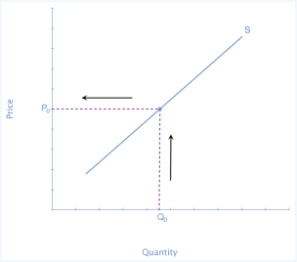


Figure 2.5.4. **Supply Curve**. The supply curve can be used to show the minimum price a firm will accept to produce a given quantity of output.

Step 2. Why did the firm choose that price and not some other? One way to think about this is that the price is composed of two parts. The first part is the average cost of production: in this case, the cost of the pizza ingredients (dough, sauce, cheese, pepperoni, and so on), the cost of the pizza oven, the rent on the shop, and the wages of the workers. The second part is the firm's desired profit, which is determined, among other factors, by the profit margins in that particular business. If you add these two parts together, you get the price the firm wishes to charge. The quantity Q_0 and associated price P_0 give you one point on the firm's supply curve, as shown in Figure 2.5.5.

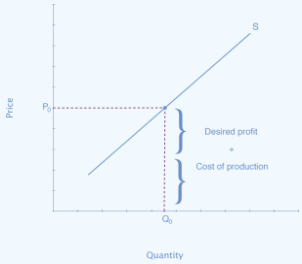


Figure 2.5.5. **Setting Prices.** The cost of production and the desired profit equal the price a firm will set for a product.

Step 3. Now, suppose that the cost of production goes up. Perhaps cheese has become more expensive by $0.75 per pizza. If that is true, the firm will want to raise its price by the amount of the increase in cost ($0.75). Draw this point on the supply curve directly above the initial point on the curve, but $0.75 higher, as shown in Figure 2.5.6.

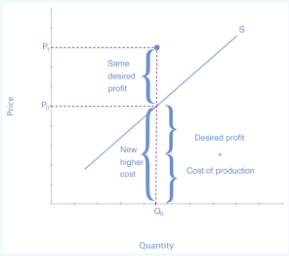


Figure 2.5.6. Increasing Costs Lead to Increasing Price. Because the cost of production plus the desired profit equal the price a firm will set for a product, if the cost of production increases, the price for the product will also need to increase.

Step 4. Shift the supply curve through this point. You will see that an increase in cost causes a leftward shift of the supply curve so that at any price, the quantities supplied will be smaller, as shown in Figure 2.5.7.

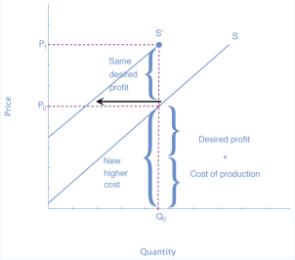
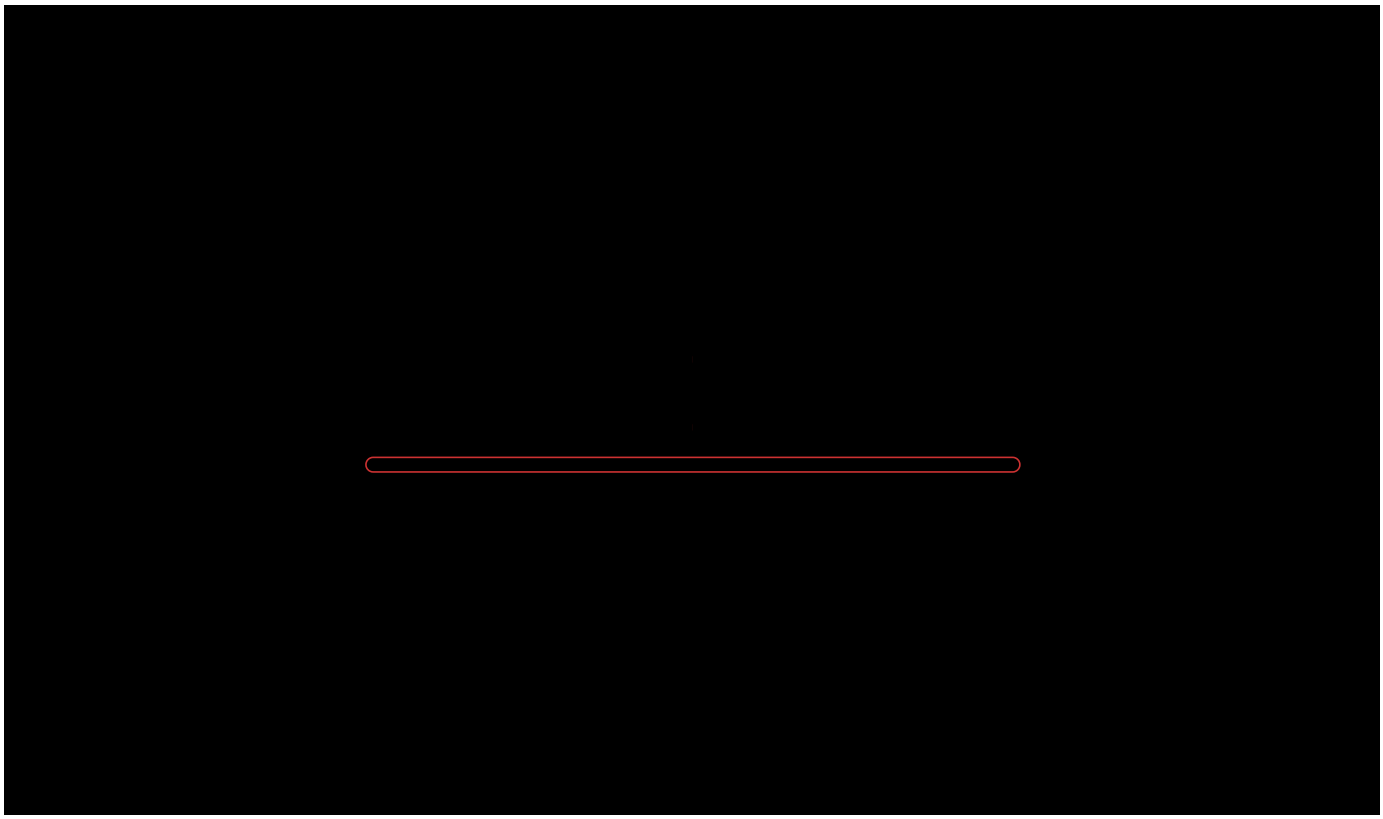


Figure 2.5.7. Supply Curve Shifted Left. When the cost of production increases, the supply curve shifts leftward to a new price level.

Simulation: Supply of Food Trucks

Play the simulation below multiple times to see how different choices lead to different outcomes. All simulations allow unlimited attempts so that you can gain experience applying the concepts.



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2.6: Equilibrium

What you'll learn to do: explain market equilibrium, surplus, and shortage

In this section, you'll learn how supply and demand interact to determine the price in a market.

Learning Objectives

- Explain equilibrium price and quantity
- Explain equilibrium price and quantity

Surpluses and Shortages

In order to understand market equilibrium, we need to start with the laws of demand and supply. Recall that the law of demand says that as price decreases, consumers demand a higher quantity. Similarly, the law of supply says that when price decreases, producers supply a lower quantity.

Because the graphs for demand and supply curves both have price on the vertical axis and quantity on the horizontal axis, the demand curve and supply curve for a particular good or service can appear on the same graph. Together, demand and supply determine the price and the quantity that will be bought and sold in a market. These relationships are shown as the demand and supply curves in Figure 2.6.1, which is based on the data in Table 2.6.1, below.

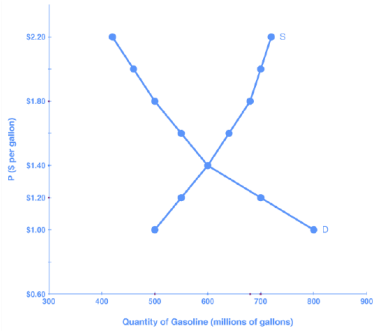


Figure 2.6.1. The supply and demand curves for gasoline.

Table 2.6.1. Price, Quantity Demanded, and Quantity Supplied

Price (per gallon)	Quantity demanded (millions of gallons)	Quantity supplied (millions of gallons)
$1.00	800	500
$1.20	700	550
$1.40	**600**	**600**
$1.60	550	640
$1.80	500	680
$2.00	460	700
$2.20	420	720

If you look at either Figure 2.6.1 or Table 2.6.1, you'll see that at most prices the amount that consumers want to buy (which we call the quantity demanded) is different from the amount that producers want to sell (which we call the quantity supplied). What does it mean when the quantity demanded and the quantity supplied aren't the same? The answer is: a surplus or a shortage.

Surplus or Excess Supply

Let's consider one scenario in which the amount that producers want to sell doesn't match the amount that consumers want to buy. Consider our gasoline market example. Imagine that the price of a gallon of gasoline were $1.80 per gallon. This price is illustrated by the dashed horizontal line at the price of $1.80 per gallon in Figure 2.6.2, below.

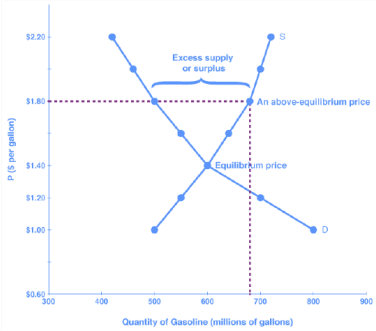


Figure 2.6.2. A price above equilibrium creates a surplus.

At this price, the quantity demanded is 500 gallons, and the quantity of gasoline supplied is 680 gallons. You can also find these numbers in Table 2.6.1, above. Now, compare the quantity demanded and quantity supplied at this price. Quantity supplied (680) is greater than quantity demanded (500). Or, to put it in words, the amount that producers want to sell is greater than the amount that consumers want to buy. We call this a situation of **excess supply** (since Qs > Qd) or a **surplus**. Note that whenever we compare supply and demand, it's in the context of a specific price—in this case, $1.80 per gallon.

With a surplus, gasoline accumulates at gas stations, in tanker trucks, in pipelines, and at oil refineries. This accumulation puts pressure on gasoline sellers. If a surplus remains unsold, those firms involved in making and selling gasoline are not receiving enough cash to pay their workers and cover their expenses. In this situation, some firms will want to cut prices, because it is better to sell at a lower price than not to sell at all. Once some sellers start cutting prices; others will follow to avoid losing sales. These price reductions will, in turn, stimulate a higher quantity demanded.

How far will the price fall? Whenever there is a surplus, the price will drop until the surplus goes away. When the surplus is eliminated, the quantity supplied just equals the quantity demanded—that is, the amount that producers want to sell exactly equals the amount that consumers want to buy. We call this **equilibrium,** which means "balance." In this case, the equilibrium occurs at a price of $1.40 per gallon and at a quantity of 600 gallons. You can see this in Figure 2.6.2 (and Figure 2.6.1) where the supply and demand curves cross. You can also find it in Table 2.6.1 (the numbers in bold).

practice question 2.6.1

The market for cement in a small town is defined by a demand curve that passes through the points ($50/ton, 300 tons), ($100/ton, 200 tons), ($150/ton, 100 tons). Meanwhile we know the supply curve passes through the points ($150/ton, 300 tons), ($100/ton, 200 tons), ($50/ton, 100 tons).

If the market starts in a surplus of 200 tons, how much must the price change before the market is in **equilibrium**?

a. decrease by $50/ton
b. increase by $50/ton
c. decrease by $100/ton

Answer

A. If there is a surplus of 200 tons then the price must be $150 (300 tons supplied - 100 tons demanded = 200 ton surplus). Equilibrium occurs at $100/ton, so the price must decrease by $50.

practice question 2.6.2

Consider the combined yearly onion supply and demand schedules for one local supermarket below. Currently the market is at the equilibrium price A. Fill in the values for A and B that would cause market equilibrium to occur at that price.

Price (per Onion)	Quantity demanded (thousands of onions)	Quantity supplied (thousands of onions)
$0.50	100	10
$0.70	90	**D?**
A?	**B?**	80
$1.10	70	120
$1.30	**C?**	160
$1.50	50	200
$1.70	40	220

a. A: $0.90; B: 90
b. A: $1.50; B: 80
c. A: $0.90; B: 80

Answer

C. To find the free market equilibrium set the quantity demanded B equal to the quantity supplied (80). The equilibrium price A must be in between $0.70 and $1.10 (i.e. $0.90)

Shortage or Excess Demand

Let's return to our gasoline problem. Suppose that the price is $1.20 per gallon, as the dashed horizontal line at this price in Figure 3, below, shows. At this price, the quantity demanded is 700 gallons, and the quantity supplied is 550 gallons.

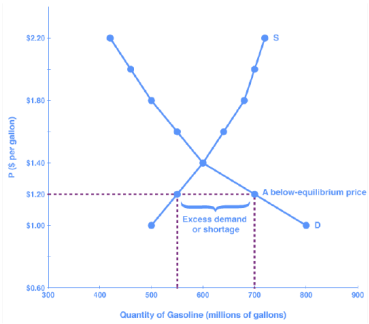


Figure 2.6.3. A price below equilibrium creates a shortage.

Quantity supplied (550) is less than quantity demanded (700). Or, to put it in words, the amount that producers want to sell is less than the amount that consumers want to buy. We call this a situation of **excess demand** (since Qd > Qs) or a **shortage**.

In this situation, eager gasoline buyers mob the gas stations, only to find many stations running short of fuel. Oil companies and gas stations recognize that they have an opportunity to make higher profits by selling what gasoline they have at a higher price. These price increases will stimulate the quantity supplied and reduce the quantity demanded. As this occurs, the shortage will decrease. How far will the price rise? The price will rise until the shortage is eliminated and the quantity supplied equals quantity demanded. In other words, the market will be in equilibrium again. As before, the equilibrium occurs at a price of $1.40 per gallon and at a quantity of 600 gallons.

Generally any time the price for a good is *below* the equilibrium level, incentives built into the structure of demand and supply will create pressures for the price to rise. Similarly, any time the price for a good is *above* the equilibrium level, similar pressures will generally cause the price to fall.

As you can see, the quantity supplied or quantity demanded in a free market will correct over time to restore balance, or equilibrium.

Equilibrium, Price, and Quantity

Equilibrium: Where Supply and Demand Intersect

Figure 2.6.4. Equilibrium is the point where the amount that buyers want to buy matches the point where sellers want to sell.

When two lines on a diagram cross, this intersection usually means something. On a graph, the point where the supply curve (S) and the demand curve (D) intersect is the **equilibrium**. The **equilibrium price** is the only price where the desires of consumers and the desires of producers agree—that is, where the amount of the product that consumers want to buy (quantity demanded) is equal to the amount producers want to sell (quantity supplied). This mutually desired amount is called the **equilibrium quantity**. At any other price, the quantity demanded does not equal the quantity supplied, so the market is not in equilibrium at that price. It should be clear from the previous discussions of surpluses and shortages, that if a market is not in equilibrium, market forces will push the market to the equilibrium.

If you have only the demand and supply schedules, and no graph, you can find the equilibrium by looking for the price level on the tables where the quantity demanded and the quantity supplied are equal (again, the numbers in **bold** in Table 2.6.1 indicate this point).

Finding equilibrium with algebra

We've just explained two ways of finding a market equilibrium: by looking at a table showing the quantity demanded and supplied at different prices, and by looking at a graph of demand and supply. We can also identify the equilibrium with a little algebra if we have equations for the supply and demand curves. Let's practice solving a few equations that you will see later in the course. Right now, we are only going to focus on the math. Later you'll learn why these models work the way they do, but let's start by focusing on solving the equations. Suppose that the demand for soda is given by the following equation:

$$Qd = 16 - 2P ,$$

where Qd is the amount of soda that consumers want to buy (i.e., quantity demanded), and P is the price of soda. Suppose the supply of soda is

$$Qs = 2 + 5P ,$$

where Qs is the amount of soda that producers will supply (i.e., quantity supplied). (Remember, these are simple equations for lines). Finally, recall that the soda market converges to the point where supply equals demand, or

$$Qd = Qs ,$$

We now have a system of three equations and three unknowns (Qd, Qs, and P), which we can solve with algebra. Since

$$Qd = Qs ,$$

we can set the demand and supply equations equal to each other:

$$Qd = Qs$$

$$16 - 2P = 2 + 5P$$

Step 1: Isolate the variable by adding 2P to both sides of the equation, and subtracting 2 from both sides.

$$16 - 2P = 2 + 5P$$

$$-2 + 2P = -2 + 2P$$

$$14 = 7P$$

Step 2: Simplify the equation by dividing both sides by 7.

$$\frac{14}{7} = \frac{7P}{7}$$

$$2 = P$$

The equilibrium price of soda, that is, the price where Qs = Qd will be $2. Now we want to determine the quantity amount of soda. We can do this by plugging the equilibrium price into either the equation showing the demand for soda or the equation showing the supply of soda. Let's use demand. Remember, the formula for quantity demanded is the following:

$$Qd = 16 - 2P$$

Taking the price of $2, and plugging it into the demand equation, we get

$$Qd = 16 - 2(2)$$

$$Qd = 16 - 4$$

$$Qd = 12$$

So, if the price is $2 each, *consumers* will purchase 12. How much will producers supply, or what is the quantity supplied? Taking the price of $2, and plugging it into the equation for quantity supplied, we get the following:

$$Qs = 2 + 5P$$

$$Qs = 2 + 5(2)$$

$$Qs = 2 + 10$$

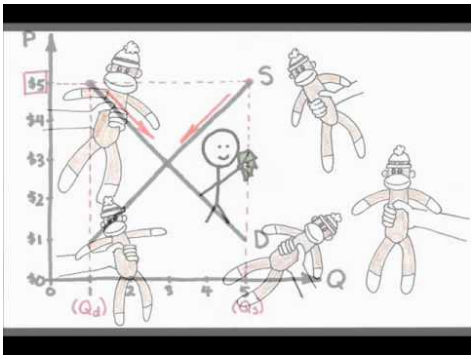
$$Qs = 12$$

Now, if the price is $2 each, *producers* will supply 12 sodas. This means that we did our math correctly, since

$$Qd = Qs$$

and both Qd and Qs are equal to 12. That confirms that we've found the equilibrium quantity.

Watch this video for a closer look at market equilibrium:



Equilibrium occurs at the point where quantity supplied = quantity demanded.

Equilibrium and Economic Efficiency

Equilibrium is important to create both a balanced market and an efficient market. If a market is at its equilibrium price and quantity, then it has no reason to move away from that point, because it's balancing the quantity supplied and the quantity demanded. However, if a market is not at equilibrium, then economic pressures arise to move the market toward the equilibrium price and equilibrium quantity. This happens either because there is more supply than what the market is demanding or because there is more demand than the market is supplying. This balance is a natural function of a free-market economy.

Also, a competitive market that is operating at equilibrium is an efficient market. Economists typically define **efficiency** in this way: when it is impossible to improve the situation of one party without imposing a cost on another. Conversely, if a situation is inefficient, it becomes possible to benefit at least one party without imposing costs on others.

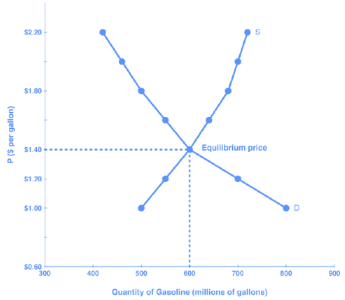
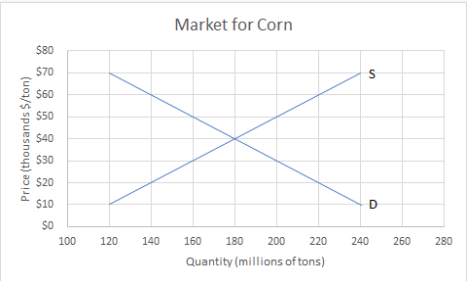


Figure 2.6.5. **Demand and Supply for Gasoline: Equilibrium**. At this equilibrium point, the market is efficient because the optimal amount of gasoline is being produced and consumed.

Efficiency in the demand and supply model has the same basic meaning: the economy is getting as much benefit as possible from its scarce resources, and all the possible gains from trade have been achieved. In other words, the optimal amount of each good and service is being produced and consumed.

practice Quesion 2.6.3

The market for corn is defined by the graph below. If the price is set at $20/ton will this result in a surplus or shortage? What is the magnitude of this surplus or shortage?



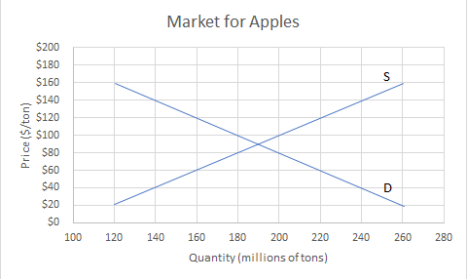
a. shortage of 120 million tons
b. surplus of 80 million tons
c. shortage of 80 million tons

Answer

C - At $20/ton the quantity supplied is 140 million tons, while the quantity demanded is 220 million tons. Since the quantity demanded is greater than the quantity supplied at the given price, then there is a shortage of 220-140=80 million tons

practice question 2.6.4

As member of the “Hungry for Apples?” national advertising campaign you are charged with analyzing future trends in Apple prices. The estimated demand and supply curve for apples is displayed below. If the current price is $100/ton, by how much must prices change before the market is in equilibrium? Is there currently a surplus or shortage in the current market for apples?



a. There is a shortage. The price must increase by $10/ton.
b. There is a shortage. The price must drop by $10/ton.
c. There is a surplus. The price must drop by $10/ton

Answer

C - The equilibrium price displayed above occurs at $90/ton. If the current price is $100/ton then there must be a surplus. Therefore the price must drop by $10/ton to arrive at equilibrium.

Finding Equilibrium using the Four-Step Process

We know that equilibrium is the place where the supply and demand curves intersect, or the point where buyers want to buy the same amount that sellers want to sell. Let’s take a closer look at how to find the equilibrium point using the four-step process. These steps explain how to first, draw the demand a supply curves on a graph and find the equilibrium. Next, consider how an economic change (e.g. a natural disaster, a change in production technology, a change in tastes and preferences, income, etc.) might affect supply or demand, then make adjustments to the graph to identify the new equilibrium point.

Step 1. Draw demand and supply curves showing the market before the economic change took place. Think about the shift variables for demand, and the shift variables for supply. Using this diagram, find the initial equilibrium values for price and quantity.

Step 2. Decide whether the economic change being analyzed affects demand or supply. In other words, does the event refer to something in the list of demand shift variables or supply shift variables?

Step 3. Determine whether the effect on demand or supply causes the curve to shift to the right or to the left, and sketch the new demand or supply curve on the diagram. In other words, does the event increase or decrease the amount consumers want to buy or the amount producers want to sell?

Step 4. Identify the new equilibrium, and then compare the original equilibrium price and quantity to the new equilibrium price and quantity.

Let’s consider one example that involves a shift in supply and one that involves a shift in demand. Then we will consider an example where both supply and demand shift.

Exercise 2.6.1: Good weather for salmon fishing

Let’s suppose that during the summer of 2015, weather conditions were excellent for commercial salmon fishing off the California coast. Heavy rains meant higher than normal levels of water in the rivers, which helps the salmon to breed. Slightly cooler ocean temperatures stimulated the growth of plankton, the microscopic organisms at the bottom of the ocean food chain, providing everything in the ocean with a hearty food supply. The ocean stayed calm during fishing season, so commercial fishing operations did not lose many days to bad weather. How did these climate conditions affect the quantity and price of salmon?

Let’s consider this situation using the four-step process and the data below.

Table 1. Salmon Fishing

Price per Pound	Quantity Supplied in 2014	Quantity Supplied in 2015	Quantity Demanded
$2.00	80	400	840
$2.25	120	480	680
$2.50	160	550	550

Table 1. Salmon Fishing

Price per Pound	Quantity Supplied in 2014	Quantity Supplied in 2015	Quantity Demanded
$2.75	200	600	450
$3.00	230	640	350
$3.25	250	670	250
$3.50	270	700	200

Let's walk through the four steps together using this example, and see how the graph changes. Use the interactive graph below (Figure 2.6.6) by clicking on the arrows at the bottom of the activity to navigate through the steps.

Figure 2.6.6 (Interactive Graph). Good Weather for Salmon Fishing: The Four-Step Process.

In short, good weather conditions increased supply of the California commercial salmon. The result was a higher equilibrium quantity of salmon bought and sold in the market at a lower price.

Exercise 2.6.2: newspapers and the internet

According to the Pew Research Center for People and the Press, more and more people, especially younger people, are getting their news from online and digital sources. The majority of U.S. adults now own smartphones or tablets, and most of those Americans say they use them in part to get the news. From 2004 to 2012, the share of Americans who reported getting their news from digital sources increased from 24 percent to 39 percent. How has this trend affected consumption of print news media and radio and television news? Figure 2.6.7 and the text below illustrate the four-step analysis used to answer this question.

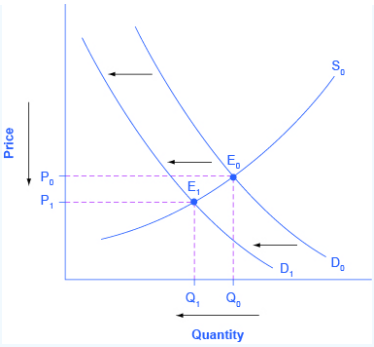


Figure 2.6.7 Graph depicting the changing market for print news.

Step 1. Draw a demand and supply model to think about what the market looked like before the event.

The demand curve D_0 and the supply curve S_0 show the original relationships. In this case, the curves are drawn without specific numbers on the price and quantity axis.

Step 2. Did the change described affect supply or demand?

Answer

A change in tastes, from traditional news sources (print, radio, and television) to digital sources, caused a change in *demand* for the former

Step 3. Was the effect on demand positive or negative?

Answer

A shift to digital news sources will tend to mean a lower quantity demanded of traditional news sources at every given price, causing the demand curve for print and other traditional news sources to shift to the left, from D_0 to D_1.

Step 4. Compare the new equilibrium price and quantity to the original equilibrium price.

Answer

The new equilibrium (E_1) occurs at a lower quantity and a lower price than the original equilibrium (E_0).

The decline in print news reading predates 2004. Print newspaper circulation peaked in 1973 and has declined since then due to competition from television and radio news. In 1991, 55 percent of Americans indicated that they got their news from print sources, while only 29 percent did so in 2012. Radio news has followed a similar path in recent decades, with the share of Americans getting their news from radio declining from 54 percent in 1991 to 33 percent in 2012. Television news has held its own during the last fifteen years, with the market share staying in the mid to upper fifties. What does this suggest for the future, given that two-thirds of Americans under thirty years old say they don't get their news from television at all?

practice question 2.6.5

Note: Using a pen and paper to illustrate supply and demand shifts could be helpful for this question

A recent health study reveals that red wine may be linked to increased longevity. At the same time, a severe drought is affecting wine production is Southern California. How will the new equilibrium quantity and price compare with the original equilibrium before the health study and drought?

a. The equilibrium price and quantity in the wine market will increase relative to the old equilibrium.
b. The equilibrium price in the wine market will increase relative the old equilibrium, yet the effect on quantity is impossible to determine.
c. The equilibrium quantity in the wine market will increase relative the old equilibrium, yet the effect on price is impossible to determine

Answer

b - A severe drought will shift the supply curve for wine to the left, while the health study will shift the demand curve right. This will result in higher equilibrium prices yet the effect on quantity is ambiguous, and depends on the magnitude of the supply and demand shifts.

practice question 2.6.6

In the past year the price of pork, the main ingredient in hot dogs, has decreased by 20%. At the same time the price of hot dog buns has also dropped 20%. How will the new equilibrium quantity and price for hot dogs compare with the original equilibrium before these price changes?

Hint: Using a pen and paper to illustrate supply and demand shifts could be helpful for this question

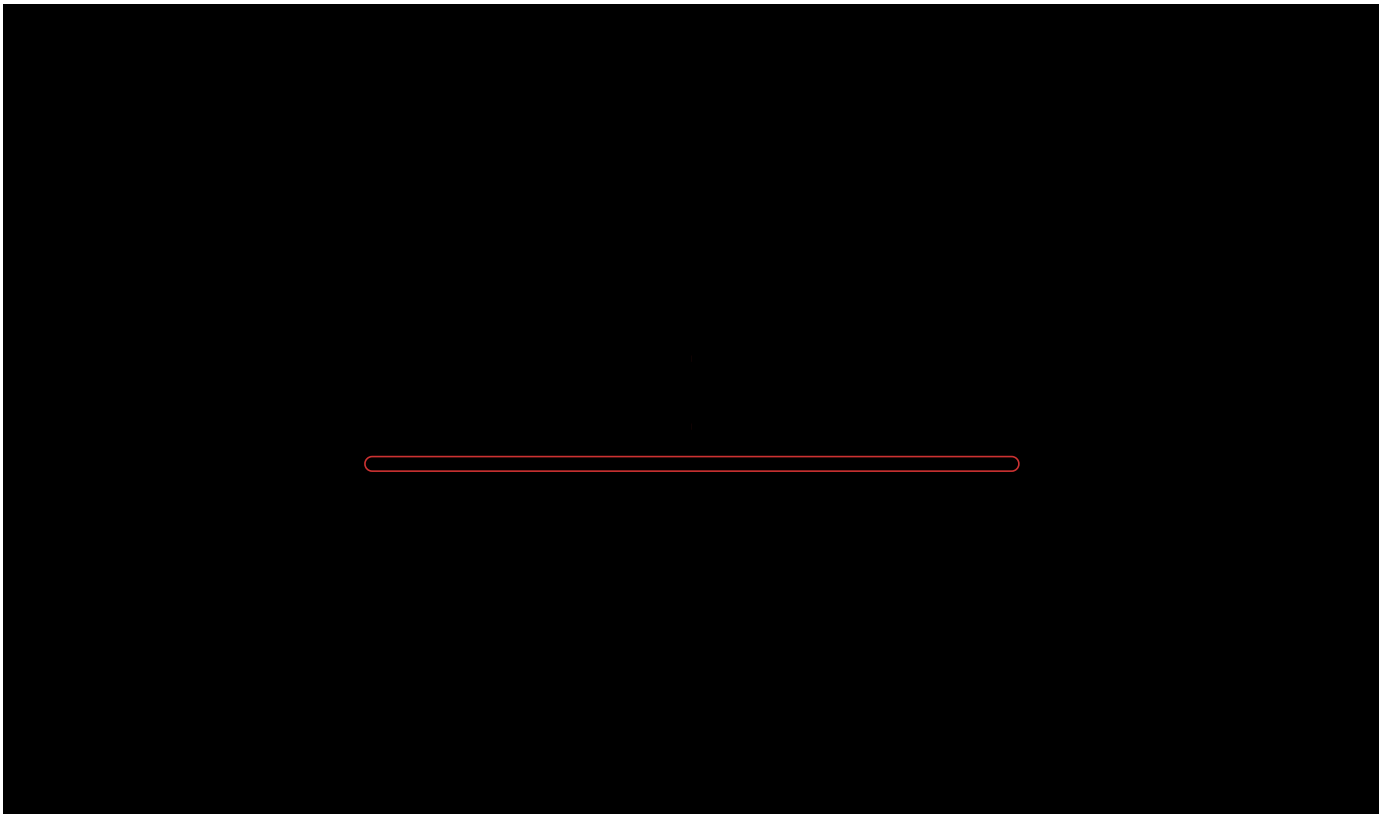
a. The equilibrium quantity in the hot dog market will increase relative the old equilibrium, yet the effect on price is impossible to determine.
b. The equilibrium price in the hot dog market will increase relative the old equilibrium, yet the effect on quantity is impossible to determine.
c. The equilibrium price and quantity in the hot dog market will increase relative the old equilibrium.

Answer

A. Lower cost of hot dog input pork will shift the supply curve to the right, while a drop in the price of hot dog buns, a complement, shifts the demand curve right. The resulting equilibrium quantity will have increased, while the effect on equilibrium price is ambiguous, and depends on the magnitude of supply and demand shifts.

Try It

Play the simulation below multiple times to see how different choices lead to different outcomes. All simulations allow unlimited attempts so that you can gain experience applying the concepts.



Practice: Equilibrium

You have seen how changes in weather can influence supply and changes in consumer preferences can reduce demand, but what happens when both supply and demand are changing? Often changes in an economy affect both the supply and the demand curves, making it more difficult to assess the impact on the equilibrium price. Let's review one such example.

Figure 2.6.8. **Money and Mail**. How do changes at the post office impact other aspects of the economy?

First, consider the following questions:

1. Suppose postal workers are successful in obtaining a pay raise from the U.S. Postal Service. Will this affect the supply or the demand for first-class mail? Why? Which determinant of demand or supply is being affected? Show graphically with before and after curves on the same axes. How will this change the equilibrium price and quantity of first-class mail?
2. How do you imagine the invention of email and text messaging affected the market for first-class mail? Why? Which determinant of demand or supply is being affected? Show graphically with before and after curves on the same axes. How will this change the equilibrium price and quantity of first-class mail?
3. Suppose that postal workers get a pay raise and email *and* text messaging become common. What will the combined impact be on the equilibrium price and quantity of first-class mail?

In order to complete a complex analysis like this it's helpful to tackle the parts separately and then combine them, while thinking about possible interactions between the two parts that might affect the overall outcome. Let's use the four-step process.

Exercise 2.6.3: Postal service

Part 1: A Pay Raise for Postal Workers

Step 1. Draw a demand and supply model to illustrate what the market for the U.S. Postal Service looks like before this scenario starts. The demand curve D and the supply curve S show the original relationships.

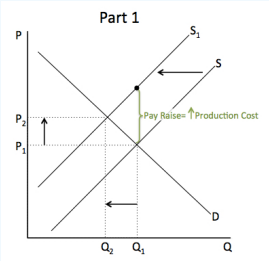


Figure 2.6.9. The supply and demand curves for the U.S. Postal Service after a pay raise for postal workers.

Step 2. Will a pay raise for postal workers affect supply or demand?

Answer

Labor compensation is a cost of production. A change in production costs cause a change in *supply* for the Postal Service.

Step 3. Is the effect on supply positive or negative?

Answer

Higher labor compensation leads to a lower quantity supplied of postal services at every given price, causing the supply curve for postal services to shift to the left, from S to S_1.

Step 4. Compare the new equilibrium price and quantity to the original equilibrium price.

Answer

The new equilibrium occurs at a lower quantity and a higher price than the original equilibrium.

A pay raise for postal workers would represent an increase in the cost of production for the Postal Service. Production costs are a factor that influences supply; thus, the pay raise should decrease the supply of first-class mail, shifting the supply curve vertically by the amount of the pay raise. Intuitively, all else held constant, the Postal Service would like to charge a higher price that incorporates the higher cost of production. That is not to say the higher price will stick. From the graph (Figure 2.6.9), it should be clear that at that higher price, the quantity supplied is greater than the quantity demanded—thus there would be a surplus, indicating that the price the Postal Service desires is not an equilibrium price. Or to put it differently, at the original price (P_1), the decrease in supply causes a shortage driving up the price to a new equilibrium level (P_2). Note that the price doesn't rise by the full amount of the pay increase. In short, a leftward shift in the supply curve causes a movement up the demand curve, resulting in a lower equilibrium quantity (Q_2) and a higher equilibrium price (P_2).

Part 2: The Effect of Email and Text Messaging

Step 1. We've already seen how a pay raise will shift the supply curve to the left. Now let's consider how the invention of email and text messaging affects the market for first-class mail. Begin by drawing a demand and supply

model reflecting this relationship.

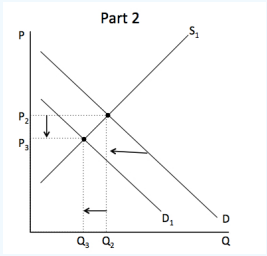


Figure 2.6.10. The impact of email and text messages on the snail mail market.

Step 2. Does email and text messaging affect supply or demand?

Answer

A change in tastes away from snail mail toward digital messages will cause a change in *demand* for the Postal Service.

Step 3. Is the effect on demand positive or negative?

Answer

A change in tastes away from snail mail toward digital messages causes lower quantity demanded of postal services at every given price, causing the demand curve for postal services to shift to the left, from D to D_1.

Step 4. Compare the new equilibrium price and quantity to the original equilibrium price.

Answer

The new equilibrium occurs at a lower quantity and a lower price than the original equilibrium.

To summarize, since many people find email and texting more convenient than sending a letter, we can assume that tastes and preferences for first-class mail will decline. This decrease in demand is shown by a leftward shift in the demand curve and a movement along the supply curve, which creates a surplus in first-class mail at the original price (shown as P_2). The shortage causes a decrease in the equilibrium price (to P_3) and a decrease in the equilibrium quantity (to Q_3). Intuitively, less demand for first-class mail leads to a lower equilibrium quantity and (ceteris paribus) a lower equilibrium price.

Part 3: Combining Factors

Parts 1 and 2 are straightforward, but when we put them together it becomes more complex. Think about it this way: in Part 1, the equilibrium quantity fell due to decreased supply. In Part 2, the equilibrium quantity also fell, this time due to the decreased demand. So putting the two parts together, we would expect to see the final equilibrium quantity (Q_3) to be smaller than the original equilibrium quantity (Q_1). So far, so good.

Now consider what happens to the price. In Part 1, the equilibrium price increased due to the reduction in supply. But in Part 2, the equilibrium price decreased due to the decrease in demand! What will happen to the equilibrium price? The net effect on price can't be determined without knowing which curve shifts more, demand or supply. The equilibrium price could increase, decrease, or stay the same. You just can't tell from graphical analysis alone. This is not unusual. When both curves shift, typically we can determine the overall effect on price or on quantity, but not on both. In this case, we determined the overall effect on the equilibrium quantity, but not on the equilibrium price.

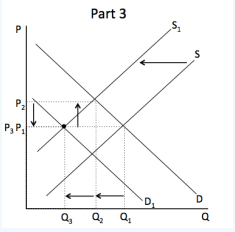


Figure 2.6.11. Decreased supply and decreased demand cause the equilibrium quantity to fall (Q_3 is be smaller than the original equilibrium quantity of Q_1). It is hard to pinpoint what happens to the price, however, as it may decline with the shrinking demand, but also increase with production costs.

practice Question 2.6.7

The past year has had very favorable growing conditions for oranges in California. At the same time, a new study reports that eating citrus fruits are linked to better health and longevity. As an economist, what movements in equilibrium quantity and price do you predict given the above information?

a. Equilibrium quantity and price will increase.
b. Equilibrium quantity will increase while price cannot be determined.
c. Equilibrium price will increase while quantity cannot be determined.

Answer

B. While rightward shifts of supply and demand will lead to a greater equilibrium quantity, it is impossible to determine the new equilibrium price without knowing which curve shifts more. You cannot tell from graphical analysis alone.

practice Question 2.6.8

Due to the negative health effects of smoking the number of cigarette consumers has steadily decreased over the past decade. During the same time period more permissive immigration laws has allowed for cheaper tobacco harvesting using migrant labor. As an economist, what movements in equilibrium quantity and price do you predict given the above information?

a. Equilibrium quantity will decrease while price cannot be determined.
b. Equilibrium price will decrease while quantity cannot be determined.

Answer

C. Lower production costs will shift the supply curve rightwards, while fewer consumers will move demand leftwards. This results in a lower equilibrium price, yet quantity cannot be determined without knowing which curve shifts more.

practice Questions 2.6.9

Here are the equations for the demand and supply curves:

Demand curve: Qd = 3300− 2 P

Supply curve: Qs = 500 + 8P

Compute the equilibrium price value.

Answer

280

Compute the equilibrium quantity value:

Answer

2740

Suppose Congress cuts personal income tax rates. How would this affect the market for air conditioners?

a. Supply curve shifts right.
b. Supply curve shifts left.
c. Demand curve shifts right.
d. Demand curve shifts left.

Answer

c. Demand Curve shifts right

Why does the demand or supply curve shift the way it does and what element of demand caused the shift? How does that affect the equilibrium price and quantity?

Answer

A decrease in tax rates effectively increases your income. An increase in income generally increases demand. Therefore demand curve shifts to the right to show an increase in the equilibrium price and quantity.

Suppose that air conditioner workers accept a pay cut of 2 dollars per hour. How would this affect the market for air conditioners?

a. Supply curve shifts right.
b. Supply curve shifts left.
c. Demand curve shifts right.
d. Demand curve shifts left.

Answer

a. Supply curve shifts right

Why does the demand or supply curve shift the way it does and what element of demand caused the shift? How does that affect the equilibrium price and quantity?

Answer

A pay cut decreases production costs for the firm. A decrease in production cost generally increases supply. Therefore supply curve shifts to the right to show a decrease in the equilibrium price and an increase in the equilibrium quantity.

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2.7: The Health of the Economy

What you'll learn to do: describe how economists evaluate the health of an economy

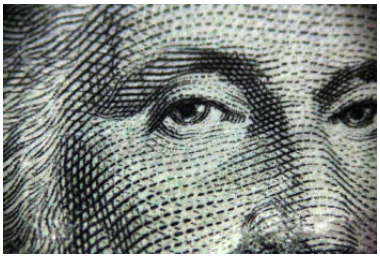
This section will help you understand why economists use terms like GDP, CPI, and unemployment rates to assess how an economy is doing.

Learning Objectives

- Explain the use of GDP as an economic indicator

Health of the Economy

Economic Indicators



When you go to the doctor with the flu, one of the first things they do is they take your temperature. If your temperature is much above 98.6 degrees, they declare you to have a fever. Depending on your other symptoms, they may prescribe you medication to bring down your fever and fight the infection. How might you (or an economist) take the temperature of an economy, so to speak, to check for health or sickness? No single measurement like body temperature will give a complete picture, so instead economists rely on what are called economic indicators. An **economic indicator** is a statistic that provides valuable information about the economy. There is no shortage of economic indicators, and trying to follow them all would be an overwhelming task. Many different economic indicators are tracked in order to evaluate the economy in different ways or from different perspectives.

Statistics that report the status of the economy a few months in the past are called **lagging economic indicators**. One such lagging indicator is the average length of unemployment. If unemployed workers have remained out of work for a long time, we may infer that the economy has been slow. Indicators that predict the status of the economy three to twelve months into the future are called **leading economic indicators**. For example, the number of building permits issued is often a good way to assess the strength of the housing market. An increase in this statistic—which tells us how many new housing units are being built—indicates that the economy is improving because increased building brings money into the economy not only through new home sales but also through sales of furniture and appliances to furnish these homes. If such a leading indicator rises, the economy is likely to expand in the coming year. If it falls, the economy is likely to slow down.

Governments, businesses, and investors use economic indicators as a measure of how well an economy is meeting its goals.

Economic Goals

The world's market-based economies all share the following three main goals:

1. Growth
2. High employment
3. Price stability

Economic indicators reveal information about how the economy is doing relative to these goals. Let's look more closely at growth, employment, and price stability and the means used to measure them.

Growth

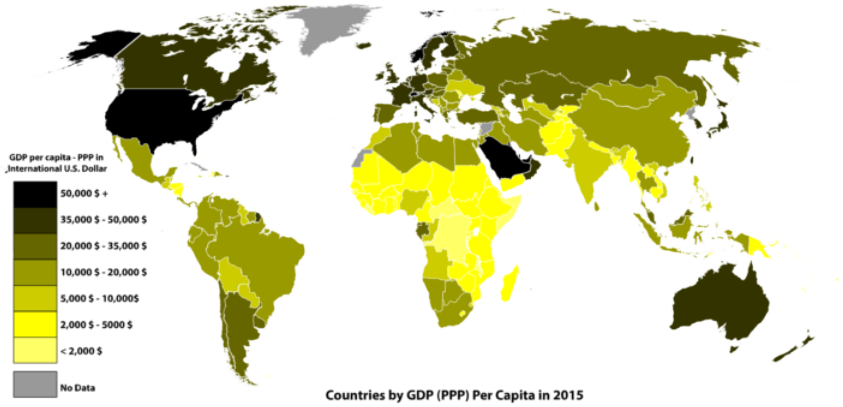
GDP

The size of a nation's overall economy is typically measured by its **gross domestic product** (GDP), which is the value of all officially recognized final goods and services produced within a country in a given period of time (usually a year). **Intermediate goods** (goods such as steel or plywood that are used as inputs in the production of other goods) are not included because they would cause double-counting to occur. GDP only refers to goods produced within a particular country. For instance, if a firm is located in one country but manufactures goods in another, those goods are counted as part of the manufacturing country's GDP, not the firm's home country. BMW is a German company, but cars manufactured in the U.S. are counted as part of the U.S. GDP.

The measurement of GDP involves counting up the production of millions of different goods and services—smart phones, cars, music downloads, computers, steel, bananas, college educations, and all other new goods and services produced in the current year

—and summing them into a total dollar value. This task is straightforward: Take the quantity of everything produced, multiply it by the price at which each product sold, and add up the total. In 2014, the U.S. GDP totaled $17.4 trillion, the largest GDP in the world.

When a country's GDP grows, its economy is likewise considered to be expanding and growing. Increases in GDP are expressed as a percentage rate of increase, and they are often expressed as GDP per capita (per person). In order to calculate GDP per capita, the GDP is divided by the total population of a country. Also, when measuring economic growth, agencies use "real GDP," which is adjusted for inflation. If the GDP figures were not adjusted for inflation, then steep rises in prices (inflation) could be mistaken for growth. Likewise, if GDP is not expressed per capita, then a country like India with a massive population would always be regarded as having one of the largest, fastest growing economies. The map, below, shows the world's GDP per capita by country.



High Employment

A country's employment level—as defined by cyclical, structural, and frictional unemployment—is one of the most important economic indicators. Unemployment has an enormous impact on business operations, from the largest multinational corporation to the smallest mom-and-pop gift shop. When people are unemployed, even temporarily, they stop spending money on nonessential goods and services, which slows down the economy. Such a slowdown leads to a decrease in revenue for businesses, which causes companies to lay off more workers, which means more unemployed people who can't purchase their goods and services. Because of this spiraling effect, unemployment is a closely watched economic indicator.

The Unemployment Rate

There are three important categories of unemployment levels that need to be understood in order to evaluate the effect of employment levels on overall economic performance: cyclical unemployment, structural unemployment, and frictional unemployment.

1. Cyclical Unemployment

Cyclical unemployment occurs when there is not enough total demand in the economy to provide jobs for everyone who wants to work. When demand for most goods and services falls, less production is needed, and, as a result, fewer workers are needed; wages generally stay put and do not fall to meet the equilibrium level, and mass unemployment results. With cyclical unemployment, the number of unemployed workers exceeds the number of job vacancies, so that even if full employment were attained and all open jobs were filled, some workers would still be without jobs. In economics, **full employment** is the level of employment rate where there is no cyclical unemployment.

2. Structural Unemployment

Structural unemployment occurs when a labor market is unable to provide jobs for everyone who wants to work because there is a mismatch between the skills of the unemployed workers and the skills needed for the available jobs. Structural unemployment may develop or increase as a result of persistent cyclical unemployment: If an economy suffers from long-lasting low aggregate demand, many of the unemployed may become disheartened, and their skills (including job-searching skills) become rusty and obsolete. The implication is that sustained high demand may lower structural unemployment. Seasonal unemployment can be seen as a kind of structural unemployment, since it's a type of unemployment that is linked to certain kinds of jobs (construction work or migratory farm work, for instance).

3. Frictional Unemployment

Frictional unemployment is the time period between jobs when a worker is searching for or transitioning from one job to another. It's sometimes called "search unemployment" and can be voluntary depending on the circumstances of the unemployed individual. Frictional unemployment is always present in an economy, so the level of *involuntary* unemployment is really the unemployment rate minus the rate of frictional unemployment. Frictional unemployment exists because both jobs and workers are heterogeneous, and a mismatch can result between the characteristics of supply and demand. Such a mismatch can be related to any of the following reasons:

- Skills
- Payment
- Worktime
- Location
- Seasonal industries
- Attitude
- Taste

There can be a range of other factors, too. New entrants (such as graduating students) and reentrants (such as former homemakers) can also suffer a spell of frictional unemployment. Workers as well as employers accept a certain level of imperfection, risk, or compromise, but usually not right away; they will invest some time and effort to find a better match. This is in fact beneficial to the economy, since it results in a better allocation of resources.

practice Question 2.7.1

Jane is an unemployed construction worker desperate to find employment so she can cover her mortgage and basic living expenses. She is willing to work for any wage, yet is unable to find any paid work given the poor state of the economy. She continues her search despite the lack of opportunities. Which of the following economic terms best describes Jane's current predicament?

a. Cyclical Unemployment
b. Voluntary Unemployment
c. Shortage of Labor

Answer

A. Cyclical Unemployment

practice question 2.7.2

Which of the following is an example of frictional unemployment as defined in the text?

a. An auto worker has received a job offer two states away, and must take off one month between jobs in order to relocate.
b. A nurse quits his job at a local hospital which is a poor fit personally. After a six month job search he becomes discouraged and exits the labor force.
c. During a severe economic downturn a large steel plant hands out redundancy notices to 1,000 employees.

Answer

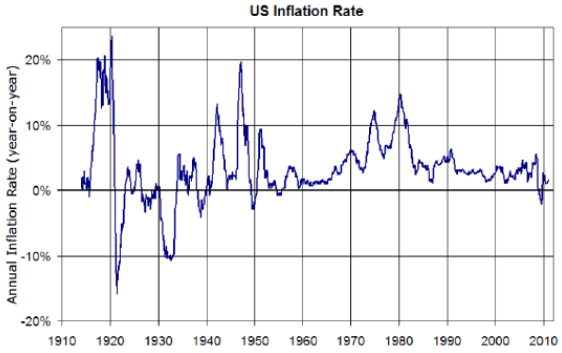
a. Relocating to a new job offer is an example of frictional unemployment

Price Stability

The third major goal of all economies is maintaining price stability. Price stability occurs when prices remain largely unchanged and there isn't rapid inflation or deflation. **Inflation** is a rise in the general price level of goods and services during a period of time; **deflation** is a decrease in the general price level of goods and services. Price stability means that the average price for goods and services either doesn't change or changes very little. Most economists believe that steady levels of low-to-moderate inflation are ideal.

As inflation pushes prices higher (slowly), businesses increase their revenues, people put more money into the system, and assets increase in value, which are all positive economic indicators. This is why economists are careful to say that a steady level of low inflation is a positive sign in the economy. As inflation rises, prices rise and values rise, which both contribute to an increase in GDP—another measure of the health of an economy. During the past three decades, inflation has been relatively low (well below 10 percent) in the U.S. economy, and this has contributed to the general stability of the economy. Inflation doesn't always increase slowly. A sudden, rapid rise in inflation is called **hyperinflation**. Argentina has recently (and repeatedly) experienced runaway inflation, with consumer prices increasing in some cases by 50 percent in a matter of days.

Figure \PageINdex1, below, shows the U.S. inflation rate from 1989 to 2009. As you can see,. Looking back at the twentieth century, there have been several periods when inflation caused the price level to rise at double-digit rates, but nothing has come close to hyperinflation.



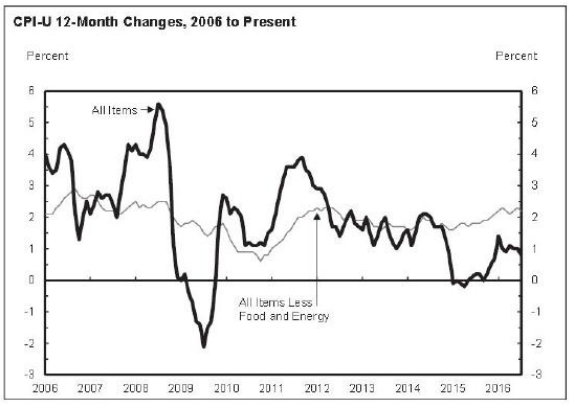
Consumer Price Index (CPI)

The most commonly cited measure of inflation in the United States is the **consumer price index** (CPI). The CPI measures changes in the price level of consumer goods and services purchased by households. The CPI in the United States is defined by the Bureau of Labor Statistics as "a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services."

The CPI market basket represents all the consumer goods and services purchased by urban households. Price data are collected for over 180 categories, which BLS has grouped into 8 major groups. These major groups, with examples of categories in each, are as follows:

- Food and beverages (ham, eggs, carbonated drinks, coffee, meals and snacks);
- Housing (rent of primary residence, fuel oil, bedroom furniture);
- Apparel (men's shirts and sweaters, women's dresses, jewelry);
- Transportation (new vehicles, gasoline, tires, airline fares);
- Medical care (prescription drugs and medical supplies, physicians' services, eyeglasses and eye care, hospital services);
- Recreation (television sets, cable TV, pets and pet products, sports equipment, admissions);
- Education and communication (college tuition, postage, telephone services, computer software and accessories);
- Other goods and services (tobacco and smoking products, haircuts and other personal care services, funeral expenses)

The CPI simplifies the measurement of changes in prices over time. By selecting an appropriate reference base and setting the average index level for that time period equal to 100, it is possible to compare this month's (or last year's) price index level with the reference base period or to any other time period. The current standard reference base period is 1982–1984=100. That is, all price changes are measured from a base (100) that represents the average index level of the 36-month period encompassing 1982, 1983, and 1984.[1]



Consumer Price Index 2006 to Present (Source: US BLS)

Consumer Confidence Index

Another important economic indicator is the **consumer confidence index**. This indicator measures the degree of optimism that consumers feel about the overall state of the economy and their personal financial situation. How confident people feel about the stability of their incomes determines their spending activity and therefore serves as one of the key indicators for the overall shape of the economy. In essence, if the economy expands, causing consumer confidence to be higher, consumers will be making more purchases. On the other hand, if the economy contracts or is in bad shape, confidence is lower, and consumers tend to save more and spend less. A month-to-month diminishing trend in consumer confidence suggests that in the current state of the economy most consumers have a negative outlook on their ability to find and retain good jobs.

The ability to predict major changes in consumer confidence allows businesses to gauge the willingness of consumers to make new purchases. As a result, businesses can adjust their operations and the government can prepare for changing tax revenue. If confidence is dropping and consumers are expected to reduce their spending, most producers will tend to reduce their production volumes accordingly. For example, if manufacturers anticipate that consumers will reduce retail purchases, especially for expensive and durable goods, they will cut down their inventories in advance and may delay investing in new projects and facilities. The government will get ready for the reduction in future tax revenues. On the other hand, if consumer confidence is improving, people are expected to increase their purchases of goods and services. In anticipation of that change, manufacturers can boost production and inventories. Large employers can increase hiring rates. Government can expect improved tax revenues based on the increase in consumer spending.

Consumer confidence is formally measured by the Consumer Confidence Index (CCI), a monthly release designed to assess the overall confidence, relative financial health, and spending power of the average U.S. consumer. The CCI is an important measure used by businesses, economic analysts, and the government in order to determine the overall health of the economy.

practice Question 2.7.3

The main economic indicators include

a. the misery index and consumer confidence index
b. gross domestic product, employment, and trade balance.
c. gross domestic product, inflation, and unemployment

Answer

c

the misery index which combines inflation and unemployment is one of the main economic indicators along with GDP but the consumer confidence index is not and neither is trade balance.

1. Source: US Bureau of Labor Statistics http://www.bls.gov/cpi/ ↵

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2.8: Economic Stages

What you'll learn to do: identify and explain the four stages of an economy (expansion, peak, contraction, and trough), and describe their impact on business operations

Spring, summer, fall and winter: the four seasons of the year. Expansion, peak, contraction, trough: the four seasons of an economy. In this next section you'll learn about the cyclical nature of economies and how each of these "seasons" affects business operations.

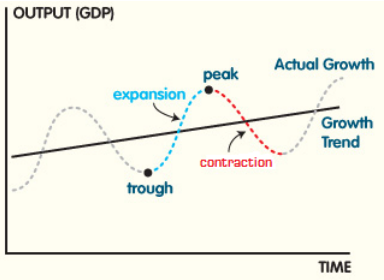
Learning Objectives

- Differentiate between expansion, recession, and depression

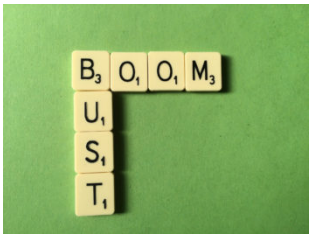
Stages of the Economy

Economic Cycle

The term economic cycle (or boom-bust cycle) refers to economy-wide fluctuations in production, trade, and general economic activity. From a conceptual perspective, the economic cycle is the upward and downward movements of levels of GDP (gross domestic product) and refers to periods of expansion and contraction in the level of economic activities (business fluctuations) around a long-term growth trend.



Stages of the Economy



Economic cycles are identified as having four distinct economic stages: expansion, peak, contraction, and trough.

An **expansion** is characterized by increasing employment, economic growth, and upward pressure on prices. A **peak** is the highest point of the business cycle, when the economy is producing at maximum allowable output, employment is at or above full employment, and inflationary pressures on prices are evident. Following a peak, the economy typically enters into a correction which is characterized by a **contraction** where growth slows, employment declines (unemployment increases), and pricing pressures subside. The slowing ceases at the **trough** and at this point the economy has hit a bottom from which the next stage of expansion and contraction will emerge. In the United States, it is generally accepted that the National Bureau of Economic Research (NBER) is the final arbiter of the dates of the peaks and troughs of the economic cycle.

Since the economy is made up of businesses (both private and public), businesses are impacted by the stages of the economy or perhaps they cause the stages of the economy – or maybe a little of both! When we move from talking about stages of the economy, the terms used to describe the business cycle differ slightly, but you will see that they are almost mirror images of the economic stages.

Business Cycle Fluctuations

Business cycle fluctuations occur around a long-term growth trend just like economic cycles, but unlike economic cycles they are measured in terms of the growth rate of **real gross domestic product (Real GDP)**. This does not mean that the GDP is imaginary, but rather that GDP does not take into account inflation. Instead, real gross domestic product is the inflation adjusted value of the goods and services produced by labor and property located in the United States.

An **expansion** is the period from a trough to a peak, and a **recession** is the period from a peak to a trough. The NBER identifies a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production." This is significantly different from the commonly cited

definition of a recession being signaled by two consecutive quarters of decline in real GDP. If the economy does not begin to expand again, then the economy may be considered to be in a state of **depression**.

Impact of the Economic Cycle on Business Operations

How the economic cycle affects business operations may be best explained by looking at how one business responds to these cycles. Normal Maintenance is a small business that provides a variety of construction services to homeowners. They specialize in roofing, deck installations, siding, and general home maintenance. They employ three full-time workers, who typically work forty hours per week for an average of twelve dollars per hour. The company has been in business in the same town for than twenty years and has a solid reputation for quality work and reliability.

Expansion

Normal Maintenance is busy and has recently had to turn down jobs because it lacks the capacity to do all the work offered. Homeowners now want to make home repairs and improvements which they had had to put off during the sour economy. With the economy improving, others are fixing up their homes to sell. Faced with so much demand, the owner of Normal Maintenance must decide whether to pay his existing workers overtime (which will increase the costs for each job and reduce profits) or hire additional workers. The competition for qualified construction labor is steep, and he is concerned that he will have to pay more than his usual rate of twelve dollars per hour or possibly get workers who are not as qualified as his current crew. He is, however, able to charge higher prices for his work because homeowners are experiencing long waits and delays getting bids and jobs completed. The owner purchases a new truck and invests in additional tools in order to keep up with the demand for services. Customers are willing to pay more than usual so they can get the work done. Business is expanding to such an extent that Normal Maintenance and its suppliers are starting to have trouble obtaining materials such as shingles and siding because the manufacturers have not kept pace with the economic expansion. In general, business is great for Normal Maintenance, but the expansion brings challenges.

Peak

At the peak of the business cycle, the economy can be said to be “overheated.” Despite hiring additional workers, the owner and crews of Normal Maintenance are working seven days a week and are still unable to keep up with demand. They can’t work any harder or faster. As a result, the crews are exhausted and the quality of their work is beginning to decline. Customers leave messages requesting work and services, but the owner is so busy he doesn’t return phone calls. Jobs are getting started and completed late as the crews struggle to cover multiple job sites. As a result, customer complaints are on the rise, and the owner is worried about the long-term reputation of the business. Neither the business nor the economy can sustain this level of activity, and despite the fact that Normal Maintenance is making great money, everyone is ready for things to let up a little.

Contraction

As the economy begins to contract, business begins to slow down for Normal Maintenance. They find that they are caught up on work and they aren’t getting so many phone calls. The owner is able to reduce his labor costs by cutting back on overtime and eliminate working on the weekends. When the phone does ring, homeowners are asking for bids on work—not just placing work orders. Normal Maintenance loses out on several jobs because their bids are too high. The company begins to look for new suppliers who can provide them with materials at a cheaper price so they can be more competitive. The building material companies start offering “deals” and specials to contractors in order to generate sales. In general, competition for work has increased and some of the businesses that popped up during the expansion are no longer in the market. In the short term the owner is confident that he has enough work to keep his crew busy, but he’s concerned that if things don’t pick up, he might have to lay off some of the less experienced workers.

Trough

On Monday morning, the crew of Normal Maintenance show up to work and the owner has to send them home: there’s no work for them. During the week before, they worked only three days, and the owner is down to his original crew of three employees. Several months ago he laid off the workers hired during the expansion. Although that was a difficult decision, the owner knows from hard experience that sometimes businesses fail not because their owners make bad decisions, but because they run out of money during recessions when there isn’t enough customer demand to sustain them. Without enough working capital to keep the doors open, some are forced to close down.

Representatives from supply companies are stopping by the office hoping to get an order for even the smallest quantity of materials. The new truck and tools that the owner purchased during the boom now sit idle and represent additional debt and costs. The company's remaining work comes from people who have decided to fix up their existing homes because the economy isn't good enough for them to buy new ones. The owner increases his advertising budget, hoping to capture any business that might be had. He is optimistic that Normal Maintenance will weather this economic storm—they've done it before—but he's worried about his employees paying their bills over the winter.

The owner of Normal Maintenance has been in business for a long time, so he's had some experience with the economic cycle. Though each stage has its stressors, he has learned to plan for them. One thing he knows is that the economy will eventually begin to expand again and run through the cycle all over again.

practice question 2.8.1

If the economy is currently experiencing high growth and inflation combined with low unemployment, it is likely to be at which phase of the business cycle?

a. trough
b. expansion
c. recession or contraction

Answer

b. Expansions tend to be characterized by positive GDP growth and decreased unemployment and increasing inflation.

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2.9: Putting It Together- Economic Environment

Synthesis

In this module you learned about the fundamental economic principles that affect the environment in which businesses operate. Understanding the economy is like getting the weather forecast before you head out the door. Might you need to pack a sweater or an umbrella or grab some sunscreen? Perhaps, like Dorothy in the *Wizard of Oz*, head for the nearest cellar? If you ignore the forecast, you can find yourself unprepared and caught in a storm. Of course economic forecasts aren't totally reliable—sometimes there's a freak weather event that no one saw coming. Nonetheless, having a basic understanding of how supply and demand work, how different economic systems function, and how the business cycle connects to the economy can help you make informed decisions—and make the best out of a rainy day.

Summary

In this module you learned about the fundamental principles of economics and how they shape the business environment. Below is a summary of the key points covered.

What Is Economics?

Economics focuses on the ways in which people, businesses, and governments make decisions when faced with scarce resources. Economists study the economy at either the microeconomic level (focus on individuals) or the macroeconomic level (focus on systems).

Economic Systems

Economic systems can be organized as traditional, planned, or market economies. Traditional systems are hunter-gatherer economies in which people consume what they produce. In command economies such as communism and socialism, the government exercises a high degree of control over production and pricing. In market economies such as capitalism, free-market supply and demand drives what is produced and consumed. The increasing complexity of the world has led to mixed economic systems that have characteristics of both command and market economies.

Demand

Demand is the amount that consumers are willing and able to purchase of a good or service at a given price. Quantity demanded is a specific quantity that will be supplied at a single point (price) on the demand curve.

Supply

Supply is the amount of a good or service that a business is willing to produce at a given price. Quantity supplied refers to a specific quantity that will be supplied at a single point (price) on the supply curve.

Equilibrium

Equilibrium is said to exist at the point where quantity supplied equals the quantity demanded, and therefore there is no excess or shortage in the market. The market is "in balance." The *equilibrium price* is the price where the amount that consumers want to purchase is equal to the quantity that the producers are willing to supply. The *equilibrium quantity* is the quantity supplied and demanded at the *equilibrium price*.

Health of the Economy

Economists use several measures to evaluate the health of an economy. Among the most important are GDP (Gross Domestic Product), the unemployment rate, and the CPI (Consumer Price Index). These three key economic indicators are used to measure how well the economy is achieving the goals of growth, high employment, and price stability.

Economic Stages

The business environment is cyclical, meaning it goes through a cycle of stages, each of which is characterized by a different set of economic conditions. The four stages of the business environment are expansion, peak, contraction, and trough.

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CHAPTER OVERVIEW

3: Global Environment

3.1: Why It Matters- Global Environment
3.2: Globalization
3.3: Measuring Global Trade
3.4: Global Buisness Strategies
3.5: Global Trade Forces
3.6: Global Trade Agreements and Organizations
3.7: Ethical Challenges in the Global Environment
3.8: Putting it Together- Global Environment

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3.1: Why It Matters- Global Environment

Why describe the characteristics, opportunities, and challenges of the global business environment?

Grab your book bag, backpack, briefcase or whatever you carry your school supplies in, and open it up. Sort the contents into two piles: items made in the United States and items made anywhere else. Now, how large is the stack of things made in the United States compared to the imported items? Some may be labeled with the store brand and say something like “Manufactured in China for Company X.” Others may simply have a tag that reads “Made in the Philippines.” How many different countries are represented by the contents of your book bag? Do you realize that you just identified a small sample of countries that are United States trading partners?

You should now have two stacks of items (made in the United States and made elsewhere). Now, take everything that is **not** made in the United States and put it aside. From this point forward all you have access to are the things left in the “100 percent made in the U.S.A.” stack. What do you have left? You will be lucky if you have a pencil and an eraser. It is global business and global trade that gives you access to everything else in your backpack.

Understanding the global business environment is critical to everyone who consumes any good, service or resource. Until we understand how the global business environment operates, why businesses and nations trade, and the forces at work in the global marketplace, we are naive consumers. You need to be informed so that you can make decisions about where you will work, who you will work for, who you will vote for, and what foreign policies you will either support or oppose. Without understanding the global business environment, you might find yourself facing daily life with nothing more than a pencil and an eraser.

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3.2: Globalization

What you'll learn to do: explain why nations and U.S. firms engage in global business

In this section you'll learn about the drivers of the global economy and how companies and countries evaluate whether or not to pursue global opportunities.

Learning Objectives

- Differentiate between comparative and absolute advantage
- Explain the roles of absolute and comparative advantage in global business

Globalization and Business

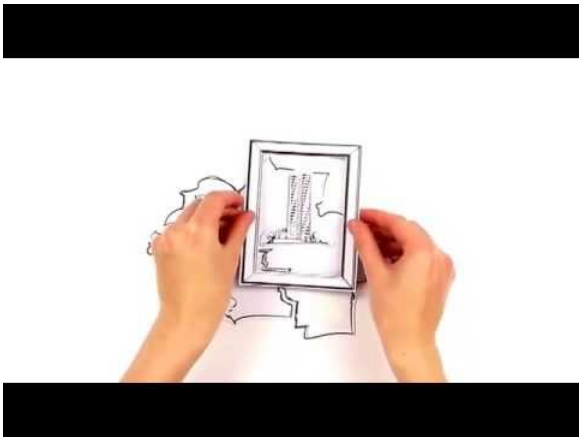
Globalization

There was a time when consumers only had access to goods and services that were available locally. Their choices were limited by what they could access on foot, by horse, or by carriage. This is still the case for many people around the world, and in rural and remote parts of the U.S., it's still necessary for families to make weekly trips to town to stock up on food, household items and other necessities. However, with the rise of Internet-based business (think Amazon), there's been an explosion of international trade, and more and more consumers essentially have the world at their door. Of course international trade isn't just a twentieth-century phenomenon. Trade across borders and between cultures has been a feature of human civilization for centuries—there's evidence of this dating back as far as the nineteenth century BCE. The Silk Road, one of the best-known and most enduring "international" trade routes, began sometime around 200 BCE and for centuries was central to cultural interaction from China through regions of the Asian continent all the way to the Mediterranean Sea.

So, if cultures and nations have been trading with one other for four thousand years, what makes today's business landscape different? The answer lies in the distinction between *international business* and *globalization*.

International business refers to commerce in which goods, services, or resources cross the borders of two or more nations. This is what the Egyptians were doing when they sent goods across the Red Sea to Assyria. **Globalization** is broader than international business and describes a shift toward a more integrated world economy in which culture, ideas, and beliefs are exchanged in addition to goods, services, and resources. Globalization implies that the world is "getting smaller": As a result of new transportation and communication technologies, people around the world can more readily connect with one another—both virtually and geographically.

The following video provides a good introduction to the causes and consequences of globalization.



Impact of Globalization on Global Business

The video, above, provides a good bird's eye view of the affect of globalization on business—from opening up new markets to increasing the level of competition within markets and industries. Let's take a look at particular example, though, to think through the various implications of conducting business on a global scale. Consider McDonald's, which was started by two brothers in San Bernadino, California, sixty-eight years ago. As a result of globalization, nearly 69 *million* people in 118 different countries eat at McDonald's every day. The first McDonald's outside the U.S. and Canada was established in Costa Rica in 1970, and since the 1990s, most of the company's growth has taken place in foreign countries. The process of building a global presence, entering new markets, and capitalizing on growing international demand for American fast food has enabled McDonald's to expand from a single location to a global corporation with revenues in excess of U.S. $25.4 billion in 2015. [1] However, entering new markets—whether at home or abroad—means contending with increased competition in those markets, including competition with other globally minded companies. In 2010, Subway surpassed McDonald's to become the largest single-brand restaurant chain and the largest restaurant operator globally.

What is it like for companies that decide to take advantage of global opportunities as McDonald's and Subway have? Return to the discussion of "external forces" in module 1, but now consider them from a global business perspective. Globalization certainly means that businesses can reach consumers around the word more rapidly and efficiently—thanks to cell phones, airplanes, and the Internet, we are all so much more interconnected and "accessible" now. But globalization also means incredible complexity. The list below sketches out just a few of the complexities and challenges that an American fast-food company like McDonald's faces when it takes on the global business environment.

The Global Economic Environment

McDonald's is a corporation based in the United States, where all business transactions are conducted using the U.S. dollar, but there are 167 official national currencies in the world, each with a different value and purchasing power. Imagine trying to balance the corporate checkbook at McDonald's when your deposits have been made in more than a hundred different currencies.

The Global Legal Environment

In Greece, there is a $650 fine for eating ice cream at certain historic, artistic, and culturally important sites. If you are the operator of a McDonald's near the Parthenon, should you remove the ice cream cones and McFlurries from your menu to protect your customers against being fined, or not?

The Global Competitive Environment

McKebab, a fast-food restaurant in Slovakia whose name and golden "M" bear a striking resemblance to McDonald's.

How does McDonald's recapture the number-one position it lost to Subway in 2010? The company may need to make substantial changes to its operations, menu offerings, and/or marketing tactics. This is a steep, uphill climb in the United States alone, but consider trying to accomplish it in 118 different countries in 188 different markets—where you are competing not only with other global U.S. fast-food companies like Subway and KFC but with local ones, like "McKebab," as well!

The Global Technological Environment

What does technology have to do with fast food or McDonald's? Consider the company's presence in China, where there are nearly 1.3 billion mobile users, and say hello to "McDonald's Next," a "modern and progressive" version of the restaurant that first opened in Hong Kong, featuring mobile-phone-charging platforms, free Wi-Fi, and self-ordering kiosks. This next generation of McDonald's is a response to increased expectations around speed, service, economy, and availability across established and developing economies, mostly fueled by consumers' growing access to affordable technology. As global businesses respond to demands created *by* technology, they must also leverage technology to move products, people, and supplies around the globe in a cost-effective and efficient manner.

The Global Social Environment

McDonald's Maharaja Mac

McDonald's has had to adapt in countless ways to meet the demands of its customers around the world. While it prides itself on offering a consistent, internationally recognizable menu and brand, the company has also had to cater to local dining preferences and customs. In 1995, for example, the first kosher McDonald's opened in a Jerusalem suburb. In Arab countries, the restaurant chain offers "halal" menus, which comply with Islamic laws governing the preparation of meat. In 1996, McDonald's entered India for the first time, where it offered a Big Mac made with lamb called the Maharaja Mac.[2]

McDonald's is not a complex business—after all, it sells inexpensive burgers and fries, not automobiles or airplanes or pharmaceuticals—but clearly the global environment presents challenges even for them. You may be wondering why nations and businesses decide to take on such challenges, given the ongoing difficulty, risk, and uncertainty. We'll investigate this question throughout the remainder of this module.

Absolute and Comparative Advantage

Consider the humble banana. Even if you're not a big fan of this yellow fruit, you've surely seen them in the grocery store or in a market somewhere. If you walked through a US city with a banana and asked people to identify it, it's unlikely you would encounter anyone who had no idea what it was. What if you did the same thing with a picture of a *banana tree*? How many people could identify it? Maybe some, but not all. Why is that? In the United States, bananas are grown in Hawaii, and not everyone has been to Hawaii. In fact, most of the bananas in the world are grown in Ecuador. If we Americans love bananas and don't live in Hawaii and can't get to Ecuador regularly, without global trade, we're out of luck: no bananas for cereal in the morning or as snacks during the day and, worse, no banana splits at the local ice cream parlor. Why do Ecuador and Hawaii trade away their bananas instead of keeping them all to themselves? Probably because, although bananas are delicious and nutritious, it's hard to build houses out of them. Instead, the state of Hawaii and nation of Ecuador choose to trade their bananas for things they lack, while considering the cost and profitability of exporting their product.

Ecuador and Hawaii offer an example of comparative advantage. Because bananas are not grown or readily available everywhere in the world, Ecuador and Hawaii can profitably export theirs to banana-less places like Iowa and Canada. At the same time, Ecuador may need computer systems to keep track of all of those bananas they are selling, but Ecuador is not a technologically advanced economy like the United States. The United States has a comparative advantage in computers, so we sell our computers to Ecuador and let them concentrate on selling us bananas.

The Concept of Advantage

In order to understand why businesses are willing to operate in a complex global environment, we must first understand two fundamental concepts that drive almost all business decisions: absolute and comparative advantage. Countries and companies are willing to assume the risk of engaging in global trade because they believe that they have an advantage over the competition that they can turn into profits. Not all countries have the same natural resources, infrastructure, labor force, or technology. These differences create advantages that can be exploited in global trade, to a country's (or company's) benefit.

Absolute Advantage

An entity (country, region, company, or individual) is considered to have an **absolute advantage** if either of the following conditions exists:

1. It is the only source of a particular product, good, or service. This kind of absolute advantage is very rare and usually depends on a particular natural resource being available only within a certain region or country. An example might be the coveted edible red bird's nests found only in the caves of Thailand (and prized in Chinese cooking as the main ingredient in bird's nest soup). Similarly, if Ecuador were the only place in the world where bananas could be grown, it would have an absolute advantage. However, suppose some sneaky banana spy goes to Ecuador and pilfers some banana tree seedlings and takes them back to her home country and begins growing and exporting bananas. At that point Ecuador no longer has an absolute advantage on the basis of the "only-source" condition.
2. An entity is also considered to have an absolute advantage if it is able to produce *more* of something than another entity while using the same amount of resources (factors of production). When the sneaky banana spy started growing bananas in her home country, she didn't actually take away Ecuador's absolute advantage, because Ecuador can produce *more* bananas using the same amount of resources (labor, land, water, equipment, etc.). Put another way, Ecuador's direct cost of producing bananas is lower than the banana spy's. Assuming that the bananas can be grown in the new country, it will take that country a very long time to match Ecuador's skill, efficiency, and output level, and until it does, Ecuador will retain its absolute advantage.

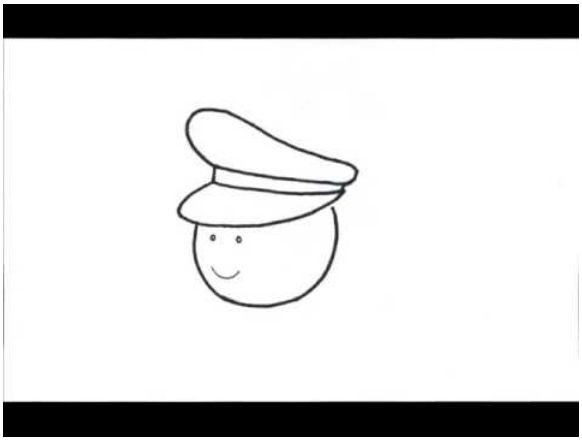
Comparative Advantage

An entity (country, region, company, or individual) is considered to have a **comparative advantage** over another in producing a particular good or service if it can produce the good or service at a lower relative opportunity cost.

You'll recall from the economic environment module that opportunity cost is the value of the *next best alternative*. (The video, below, also includes a refresher on this concept.) Since countries and businesses have limited resources, they are forced to make choices about how they allocate those resources. As a student, you understand opportunity cost better than you think. You have a limited amount of time, and you must choose between reading this module and going out with your friends, because you can't do both. If you choose to go out with your friends, then the opportunity cost might be failure on your next exam because you did not use the time to prepare.

Ecuador has a comparative advantage in bananas over a long list of countries, including the United States. This comparative advantage is even better understood when you consider that their *next best alternative* product is oil. The Middle Eastern countries have been pumping oil from the ground for as long as Ecuador has been growing bananas. It makes as much sense for Kuwait to attempt to export bananas as it does for Ecuador to export oil. It's the reality of comparative advantage that encourages countries and businesses to do what they do best—leaving the production of other goods and services to other countries or companies—and in so doing, focusing on producing goods and services where they have advantage, thus maximizing their opportunities in a global environment.

The following video provides an excellent illustration of comparative and absolute advantage and explains why they are such important considerations in how countries decide to specialize and trade.



practice question 3.2.1

Consider an economy that has an absolute advantage in producing a given product, then it _____ have a comparative advantage in producing that same product.

a. must
b. might or might not
c. definitely

Answer

b. Absolute advantage means the economy can produce a given product with a lower resource cost and comparative advantage means the economy can product a given product with a lower opportunity cost. Absolute advantage meaning being better at something relative to something else. Specialization allows for everyone benefiting from producing under comparative advantage and then trading.

practice question 3.2.2

If Kate can make more tacos in an hour than Bill, but Bill can make more tacos at a lower opportunity cost then Bill has a(n) _____.

a. absolute advantage in making tacos.
b. both an absolute and comparative advantage in making tacos.
c. comparative advantage in making tacos.

Answer

c. Kate has an absolute advantage because she can make more tacos and Bill has a comparative advantage because he can make more tacos at a lower opportunity cost.

Game: Absolute and Comparative Advantage

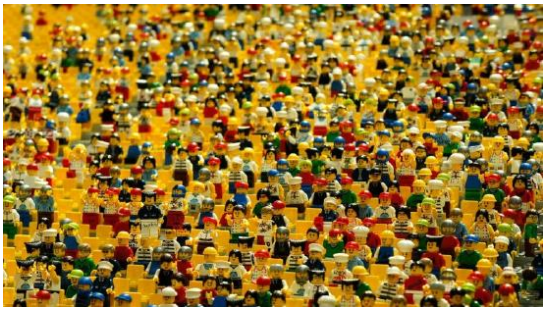
It's one thing to talk and read about global business and another to actually engage in global trade. The following interactive provides a brief introduction to doing just that, with a focus on just how countries behave to create a more productive global economy.

learn more

Now that you've learned about specialization, you can try playing this trade game to explore trade in a fictional world: Play the Trade Ruler Game. Note that this game is Flash-based, so you'll need to enable Flash in your browser in order to see it.

Global Markets

Global Markets and Business Opportunity



Increasingly nations and business use their comparative or absolute advantages to enter global markets driven by the same factor: the immense *size* of these markets.

Let's return to the banana for a moment. In 2015, Ecuador exported 6.55 *million metric tons* of bananas. Without a large global demand for bananas, every man, woman, and child in Ecuador would have to eat 834 pounds of them per year to consume all of the production. Of course that wouldn't happen: Instead, the country would simply cut back on the production of bananas—but, in so doing, it would lose an export that now accounts for more than 10 percent of its gross domestic product (GDP). Ecuador needs a large and vibrant global market to keep up with its tremendous supply of bananas, and it relies on the revenue from those bananas to purchase the other things it needs (in the same way that you traded cell phones for blue jeans in the island trader simulation).

Later in this module we'll discuss how nations like Ecuador enter foreign markets, but for now let's look more closely at the size of the world's largest markets. The following table shows population and GDP data for the top five economies in the world as of 2015.[3] You'll recall from the economic environment module that GDP, or gross domestic product, is a monetary measure of the market value of all final goods and services produced in a period, and the GDP growth rate is the increase or decrease in GDP over a period of time, expressed as a percentage.

Country	GDP	Population	GDP Growth Rate
China	$19,390,000,000,000	1,367,485,388	6.90%
European Union	$19,180,000,000,000	513,949,445	2.20%
United States	$17,950,000,000,000	321,368,864	2.40%
India	$7,965,000,000,000	1,251,695,584	7.30%
Japan	$4,830,000,000,000	126,919,659	0.50%

Looking at the figures in this table, it isn't hard to imagine that a country or company would like to have a foothold in one or all of these markets. Taken together, these five economies represent a lot of people, a lot of purchasing power, and a lot of economic growth. However, the immensity of the global market offers more than just new target customers. Consider some of the following benefits nations and firms realize by entering foreign markets.

Access to Factors of Production

You will recall that the factors of production required for a successful business venture are natural resources, capital, human capital, and entrepreneurship. Access to global markets enables countries and companies to acquire these factors of production when they are nonexistent, scarce, or just too costly at home. For example, India is one of the largest providers of telephone-based customer service (labor) worldwide, which makes sense given that its population is second only to China and almost four times that of the United States. In addition, labor costs in India are significantly lower than in the U.S.

Innovation and Ideas

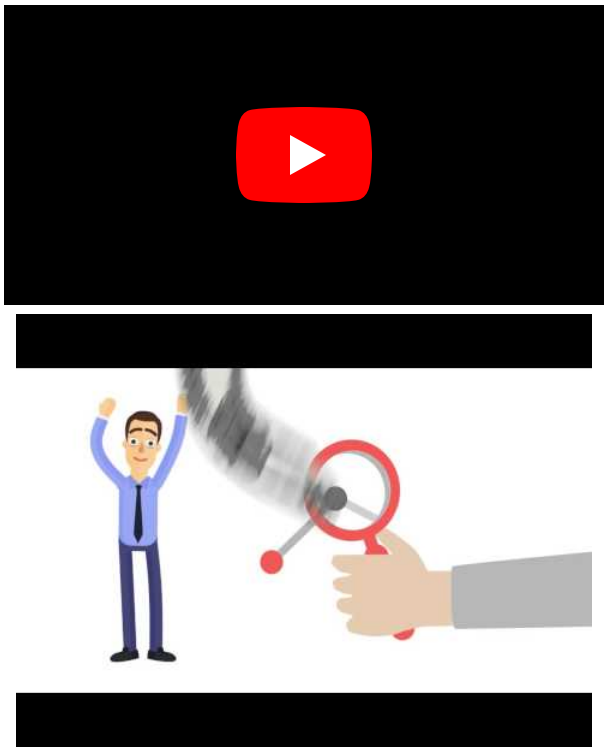
Many companies enter global markets and, once there, discover unmet needs or unique products and services. They are then able to use their discoveries to expand an existing product line or introduce new products in other markets or at home. For example, many people credit the United Kingdom with inspiring the development of the craft beer industry in the United States.

Risk Reduction

Given the complexity of operating a business globally, it may seem like a contradiction that risk reduction is one of the benefits of a large global market, but it's actually true. If a country or a company trades or does business with multiple foreign partners, they are less dependent on the success of any single partnership. Likewise, if a nation or business has *multiple* global sources for factors of production, then if one source "dries up," they will still have access to what they need. For example, in 2010 China halted its export of rare earth minerals to Japan after the two countries were unable to resolve a territory dispute. Japan used these minerals in the production of everything from cars to computer chips, and to say that the Japanese were in a state of distress is an understatement. As a result of this albeit brief reduction in Chinese supply, Japan established a trade agreement with India for the import of the needed materials. They will no longer be totally dependent upon the Chinese for these important resources.

In summary, globalization makes business on a global scale possible, and the size of the global market makes it attractive. By using their absolute and comparative advantages, countries and companies can leverage their resources to produce and trade the things that benefit them the most.

The following video provides a recap of the main reasons why countries and businesses engage in global trade.



1. https://en.Wikipedia.org/wiki/McDonald%27s ↵
2. en.Wikipedia.org/wiki/History_of_McDonald ↵
3. CIA World FactBook https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html#ch ↵

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3.3: Measuring Global Trade

What you'll learn to do: describe how nations measure global trade

In the same way that nations measure their own economic productivity, they use specific tools to measure their trade with other nations. In this section you'll learn what some of those tools are and how they're used.

Learning Objectives

- Differentiate between trade deficits and trade surpluses
- Explain how countertrade contributes to the measure of global trade

Balance of Trade and Balance of Payments

Nations and businesses that trade back and forth, buy and sell companies, loan one another money, and invest in real estate around the globe need to have a way to evaluate the impact of these transactions on the economy. They need to make decisions about trade policies, regulations, and trade agreements, and until they can get a snapshot of what global trade is doing to hurt or help its economy, they can't make these decisions. It's a lot like your own finances, just on a much larger scale. At the end of the month have you spent more than you earned? Do you have a large positive balance in your bank account as a result of receiving a financial aid check? Did you need to borrow money from your parents to buy books or clothes? Until you really examine where your money is coming from and balance your checkbook, it's hard to make long-term financial plans—like, say, deciding whether or not to buy a new car or purchase a home. This is very similar to what countries do when they measure the impact of trade on their economy.

In this section we'll look at two key measurements of trade: balance of trade and balance of payments.

Balance of Trade

One of the ways that a country measures global trade is by calculating its **balance of trade**. Balance of trade is the difference between the value of a country's imports and its exports, as follows:

value of exports – value of imports = balance of trade

Note

It's important to use this formula just as it's presented, without altering the sequence of values.

The calculation of the balance of trade yields one of two outcomes: a trade deficit or a trade surplus. A **trade deficit** occurs when a nation imports more than it exports. Since 1976, the United States has consistently run trade deficits due to high imports of oil and consumer products. In recent years, the biggest trade deficits were recorded with China, Japan, Germany, and Mexico. This shouldn't come as a surprise to you if you emptied your backpack and counted up all the items *not* made in the United States. In contrast, a **trade surplus** occurs when a nation exports more than it imports. Although the United States has run an overall trade deficit since 1976, it doesn't mean that we import more from *every* country than we export. On the contrary, the United States records trade surpluses with Hong Kong, the Netherlands, the United Arab Emirates, and Australia. Because the balance of trade is calculated using **all** imports and exports, it's possible for the United States to run a surplus with some nations and a deficit with others. As with your checkbook, the balance reflects the difference between *total* exports ("deposits") and *total* imports ("withdrawals").

candyland's balance of trade

Let's look at the balance of trade for "Candyland."

Candyland is located in a region that lacks phosphate as a natural resource. However, it does have an abundance of sugarcane. As a result of its comparative advantages, Candyland imports phosphate

from Christmas Island (it's a real place in Australia—look it up!) to fertilize the sugarcane it grows, and it uses the sugarcane to manufacture saltwater taffy, which it exports to Christmas Island. The following table shows Candyland's imports and exports with Christmas Island in 2014.

	Imports (phosphate)	Exports (taffy)
2014	$45,000,000	$75,000,000

Using these figures, we can easily calculate Candyland's balance of trade in 2014:

$75,000,000 (exports) − $45,000,000 (imports) = $30,000,000

This means that Candyland had a trade surplus of $30,000,00 with Christmas Island, since exports exceeded imports. We can also say that Candyland was a "net exporter," meaning they exported more than they imported.

However, the picture changed in 2015 when the Australian government closed the phosphate mine on Christmas Island. Candyland had to import phosphate from Morocco, instead, and was not able to get the same favorable pricing as before. Consequently, sugarcane farmers paid more for fertilizer, the price of sugarcane went up, and Candyland had to raise the price on its saltwater taffy. Sadly, the people of Morocco aren't really big fans of saltwater taffy, so exports fell. The following table shows Candyland's imports and exports with Morocco in 2015.

	Imports (phosphates)	Exports (Taffy)
2015	$65,000,000	$55,000,000

We can use the figures to calculate Candyland's balance of trade:

$55,000,000 (exports) − $65,000,000 (imports) = −$10,000,000

The negative number indicates a trade deficit of $10,000, showing that Candyland's imported more from Morocco than it exported. We would say that Candyland became a "net importer"—importing more than it was exporting.

Obviously this is a simple example. A country's global business doesn't amount to just trading phosphate and taffy or cell phones and blue jeans. It includes all kinds of financial transactions: goods and services imported and exported, foreign investments, loans, transfers, and so on. Tracking all these payments provides another way to measure the size of a country's international trade: the balance of payments.

Balance of Payments

Balance of Payments is the difference between the total flow of money coming into a country and the total flow of money going out of a country during a period of time. Although related to the balance of trade, balance of payments is the record of **all** economic transactions between individuals, firms, and the government and the rest of the world in a particular period. Thus the balance of

payments includes **all** external transactions of a country, including payments for the country's exports and imports of goods, services, foreign investments, loans and foreign aid, financial capital, and financial transfers.

- For instance, if a US company buys land or a factory in another country, that investment is included in the US balance of payments as an *outflow*. Likewise, if a US company is sold to a foreign company, it's included in the balance of payments. Just recently, Didi Chuxing, the Chinese ride-hailing service, bought Uber's subsidiary in China in a deal valued at $35 billion. This sale will create a *cash inflow* to the United States, but over the long term it will decrease the revenue flowing in from China through Uber.
- If a nation receives foreign aid or borrows money from another country, this amount is also reflected in its balance of payments as a *cash inflow*. For example, the bailout Greece received from the Eurozone and IMF in 2010 to help stabilize its failing economy affected the balance of payments for all of the nations involved. Greece recorded the €110 billion loan as an *inflow* in its balance of payments, while the Eurozone members recorded it as an *outflow* in their balance of payments.

A country's balance of payments is calculated as follows:

total money coming into a country (inflow)− total money going out (outflow) = balance of payments

Note

It's important to use this formula just as it's presented, without altering the sequence of values.

Candyland's balance of payments

Let's examine Candyland's balance of payments in 2015. The following table shows all of its external transactions during the year.

	Imports (phosphates)	Exports (taffy)	Foreign aid (loan) from Hooperland	Purchase of Wandaland assets
2015	$65,000,000	$55,000,000	$25,000,000	$30,000,000

When we calculated Candyland's balance of trade in 2015, we *did not* take into account the following two transactions:

1. Candyland invested in a factory in Wandaland and purchased the factory from the government for $30,000,000. This *outflow* of funds will affect Candyland's balance of payments.

When we calculate Candyland's 2015 balance of payments, by taking the inflows (revenue from exports and foreign aid) and subtracting the outflows (payments for imports and purchase of foreign assets), the balance is negative, as shown below:

($55,000,000 + $25,000,000) (total inflow) – ($65,000,000 + $30,000,000) (total outflow) = −$15,000,000

What effect will this have on Candyland? Well, when Candyland's leader is briefed by her council of international economic advisers, they will inform her that the country currently has an "unfavorable balance of payments." That is, less money is coming into the country than is going out. If, on the other hand, the balance of payments were a positive number (inflow exceeded outflow), Candyland could say that it has a "favorable balance of payments."

At this point it's tempting to make judgments about these different types of trade measurements and conclude that trade surpluses and favorable balance of payments are always indicators of a strong economy, but unfortunately it's not so cut and dried. Balance of trade and balance of payments are starting points—much in the way that an individual's credit rating might be a starting point for

seeking a loan. How the numbers are interpreted and viewed by the country's leaders, other countries, and the world depends on many factors, such as where a country is in its economic development, the factors contributing to the balance of trade or payments, the health of the overall global economy, what the country is doing with its imports, and so on. As you might guess, assessments of these factors can be intensely political. You'll learn more about these considerations later in this module when we discuss how nations attempt to restrict or control trade.

Countertrade

So far we have discussed global trade measured in dollars, euros, or other traditional currency, which is the way that everyone assumes business is conducted today. For example, here in the United States, we express the size of the global market, or Global World Product (GWP), as U.S. $107.5 trillion. If we lived in Japan, we'd measure GWP using Japanese currency, yen (¥).

However, when we measure global trade *only* in terms of currency-based transactions, we omit a portion of the market known as countertrade. **Countertrade** is a system of exchange in which goods and services are used as payment rather than money. There are many types of countertrading. Some of the most common types are described below:

1. **Barter**: Exchange of goods or services directly for other goods or services without the use of money as means of purchase or payment. Example: One party trades salt for sugar from another party.
2. **Switch trading**: Practice in which one company sells to another its obligation to make a purchase in a given country. Example: Party A and Party B are countertrading salt for sugar. Party A may switch its obligation to pay Party B to a third party, known as the switch trader. The switch trader gets the sugar from Party B at a discount and sells it for money. The money is used as Party A's payment to Party B.
3. **Counterpurchase**: Sale of goods and services to one company in another country by a company that promises to make a future purchase of a specific product from the same company in that country. Party A sells salt to Party B. Party A promises to make a future purchase of sugar from Party B.
4. **Buyback**: This occurs when a firm builds a plant in a country, or supplies technology, equipment, training, or other services to the country, and agrees to take a certain percentage of the plant's output as partial payment for the contract. Example: Party A builds a salt-processing plant in Country B, providing capital to this developing nation. In return, Country B pays Party A with salt from the plant.
5. **Offset:** Agreement that a company will offset a hard-currency purchase of an unspecified product from that nation in the future. Agreement by one nation to buy a product from another, subject to the purchase of some or all of the components and raw materials from the buyer of the finished product, or the assembly of such product in the buyer nation. Example: Party A and Country B enter a contract where Party A agrees to buy sugar from Country B to manufacture candy. Country B then buys that candy.

Countertrading is common among countries that lack sufficient hard currency (i.e., cash) or where other types of market trade are impossible. In developing countries, whose currency may be weak or devalued relative to another country's currency, bartering may be the only way to trade. For example, if the value of Venezuela's currency, the *bolívar fuerte*, falls relative to the U.S. dollar (as it has in recent years), the exchange rate makes it unfavorable for Venezuela to sell its oil to the United States. Countertrade may be a much more financially beneficial arrangement.

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3.4: Global Buisness Strategies

What you'll learn to do: evaluate common strategies used to reach global markets

Globalization introduces a number of challenges that are unique to operating simultaneously in different countries and global markets. What is the best way to enter or take advantage of a global market? When should you adjust a product's features to customize it to consumer needs in a different global market? How do you manage the costs and complexities of producing and/or promoting products in different locations, with different languages, cultural sensitivities, and consumer expectations?

While this next section doesn't attempt to answer all of these questions, it explains common strategies and approaches used by multinational corporations to take advantage of global business opportunities.

Learning Objectives

- Explain how firms use licensing and franchising to reach global markets
- Explain how firms use joint ventures and foreign strategic alliances to reach global markets

Global Business Strategies

In today's economy, once a nation or business has developed an advantage—either comparative or absolute—it's likely to look beyond its own borders or storefront to seek greater economic opportunity. But how do you enter a global market? It's certainly not as simple as loading up your products in a van, driving to the next town, and knocking on doors. Below are some of the common strategies companies and countries use to get their goods and services into global markets.

Exporting/Importing

Figure 3.4.1. Shipping Containers

Exporting is the easiest and most straightforward way to engage with the global market. **Exporting** is taking goods that were produced within a company's home country and shipping them to another country. The party sending the good is called an *exporter*. It is impossible to discuss exporting without mentioning its complement, importing. **Importing** is the process by which a good is brought into a jurisdiction, especially across a national border, from an external source. The party bringing in the good is called an *importer*. Simply put, one country's exports become another country's imports. Examples of U.S. imports are everywhere: Take a look at the labels in your clothes or the contents of your backpack. From our vantage point, U.S. exports may be a little harder to see, but they exist all the same and are plenty visible in other countries. According to *World's Top Exports*, the following export product groups represent the highest dollar value in American global shipments during 2015. In parentheses is the percentage share each export category represents in terms of overall U.S. exports:

1. Machines, engines, pumps: US$205.8 billion (13.7% of total exports)
2. Electronic equipment: $169.8 billion (11.3%)
3. Aircraft, spacecraft: $131.1 billion (8.7%)
4. Vehicles: $127.1 billion (8.4%)
5. Oil: $106.1 billion (7.1%)
6. Medical, technical equipment: $83.4 billion (5.5%)
7. Plastics: $60.3 billion (4%)
8. Gems, precious metals, coins: $58.7 billion (3.9%)
9. Pharmaceuticals: $47.3 billion (3.1%)
10. Organic chemicals: $38.8 billion (2.6%)[1]

Advantages and Disadvantages

Since exporting doesn't require a company to manufacture its products in the target country, the company doesn't have to invest in factories, equipment, or other production facilities located halfway around the globe. Most of the costs involved in exporting are associated with finding a buyer or distributor in the destination market. For these reasons, exporting is considered to be the quickest and least expensive means to enter the global market. However, there are disadvantages, too.

Once products arrive in the destination market, the business loses control of them, which can result in products being misrepresented, copied by other manufacturers, or even sold on a black market. In addition, because the business isn't active in the new market, it can't gain insight into or experience with local consumer preferences and demand. This lack of information can create uncertainty and potentially cost the company opportunities down the road. As you will learn later in this module, businesses operating in other countries may find themselves subject to taxes, regulations, and/or restrictions that can substantially affect the profitability of the entire export venture.

Outsourcing/Offshoring

Figure 3.4.2 Garment factory, Jiaxing, China

Outsourcing and offshoring are two additional strategies that a business can use in order to take advantage of the global market. **Outsourcing** *contracts out* a business process to another party and may include either or both foreign and domestic contracting. You may be familiar with outsourcing if your college has outsourced the bookstore to a national chain such as Barnes & Noble, or the food services are provided by a company such as Starbucks or Aramark. Although the employees work on your college campus, they are not college employees. **Offshoring**, on the other hand, is the actual *relocation* of a business process from one country to another—typically it's an operational process, such as manufacturing, or sometimes a supporting process, such as accounting. In the case of offshoring, the employees still work for the company that's offshoring its operations, but instead of working in a facility within the United States, they are located in a foreign country. In general, outsourcing and offshoring are strategies that companies use to try to lower their costs.

If a business chooses outsourcing as a way to engage with the global market, it might have a single component part manufactured in, say, Tibet and then shipped back to Iowa, where the factory workers in Iowa would use the outsourced part in the assembly of the final product. The business would have a contract with the company making the component part at an agreed-upon price, but it would not have an employer-employee relationship with the workers in Tibet. On the other hand, if the business wants to take advantage of offshoring, it would move the entire plant from Iowa to Tibet and hire workers in Tibet who would work directly for the business.

The following video is an example of how a small business is outsourcing its manufacturing to China. Especially for small start-up companies, using established manufacturing facilities located outside of the U.S. allows them to enter the global marketplace. Cost, logistics, finances, and speed are just some of the things that this type of arrangement can bring to businesses looking to take advantage of the growing global demand for U.S.-branded products.

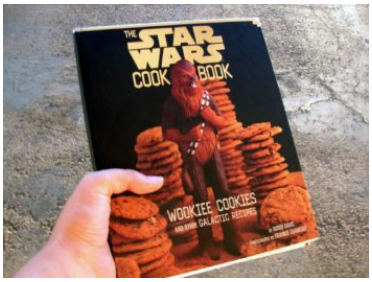
Advantages and Disadvantages

Offshoring and outsourcing are both the subject of ongoing heated public debate—both in the U.S. and in other countries. Those in favor assert that these strategies benefit both sides of the arrangement: Free trade is enhanced, the destination country gains jobs, and the origin country gets cheaper goods and services. Some supporters go further and assert that outsourcing and offshoring raise the gross domestic product (GDP) and increase the total number of jobs domestically, too. This claim is based on the idea that workers who lose their jobs will move to higher-paying jobs in industries where the origin country has a comparative advantage.

On the other hand, job losses and wage erosion "at home" have sparked opposition to offshoring and outsourcing. Many argue that the jobs that are shipped overseas are not replaced by better, higher-paying ones. And it's not just low-skilled workers who are feeling the pain. Increasingly, critics say, even highly trained workers (such as software engineers) with high-paying jobs are finding themselves replaced by cheaper workers in India and China. Some firms, while realizing financial gains from lowering their production costs, are finding that offshoring and outsourcing are very costly in terms of lack of control over product quality, working conditions, and labor relations. For example, companies like Nike and Apple have come under fire by human rights organizations and consumers over reports of worker abuse, dangerous working conditions, and ridiculously low wages. It was recently reported that apparel workers in Bangladesh are sometimes paid as little as $0.21 per hour. We will explore some of the ethical issues raised by offshoring and outsourcing later in the course in the business ethics module.

Licensing and Franchising

Figure 3.4.3 The Star Wars Cookbook



Increasingly, businesses are getting their products and services into global markets via licensing and franchise agreements. Under a **licensing agreement**, the licensor agrees to let someone else (the licensee) *use* the property of the licensor in exchange for a fee. License agreements usually cover property that is intangible, such as trademarks, images, patents, or production techniques. Since its debut in the late 1970s, *Star Wars* remains the most lucrative source of licensing in the entertainment business, generating more than $42 billion from the sale of licensed merchandise.

A longer-term and more comprehensive way to access the global market is through franchising. Under the terms of a franchise agreement, a party (franchisee) acquires access to the knowledge, processes, and trademarks of a business (the franchisor) in order to sell a product or service under the business's (franchise's) name. In exchange for the franchise, the franchisee usually pays the franchisor both initial and annual fees. McDonald's, Holiday Inn, Hertz Car Rental, and Dunkin' Donuts have all expanded into foreign markets through franchising.

Advantages and Disadvantages

Licensing and franchising both offer advantages for the involved parties: The licensee and franchisee both gain a competitive advantage in the market. The licensee/franchisee gets immediate brand recognition and may quickly overtake the competition by offering a product or service for which there is existing unmet demand. For example, a local sandwich shop may have a hard time competing when a Subway franchise opens because the brand is so well known. Also, because franchises are usually "turnkey" operations in which processes, supply chains, training, and products are already in place, the new business can quickly begin efficient and profitable operations. For the franchisor, this arrangement enables them to gain inexpensive access to a new market,

since the initial cost of the franchise is borne by the franchisee. Under a licensing agreement, all of the costs of production, sales, and distribution are the responsibility of the licensee. If financial capital is scarce, both approaches allow companies to have a global presence without heavy investments.

These methods do contain some risks and disadvantages, however. They are typically the least profitable way of entering a foreign market, since the profits go to the franchisee or licensee. Although the licensor or franchisor receives up-front money and/or a small percentage of future sales, the majority of the revenue remains in the destination country with the licensee or franchisee. Franchising entails a long-term commitment on the part of the franchisor to provide ongoing support in the form of training, logistics, product development, and brand marketing. Once a business begins to establish a global franchise presence, the pressure to maintain brand integrity and fiscal responsibility becomes more intense as the failure of the franchise now has global consequences. For companies selling licensing rights there is a risk that their intellectual property may be misrepresented or used in a manner that could tarnish the brand's image. Also, once a license to use an image or other intellectual property has been granted to a company in another country, the probability that knock-off products will enter the market goes up. For both franchisors and licensors, maintaining quality standards on a global scale is a massive undertaking, and for this reason many companies are choosing to exert a higher degree of control over their products, brands, and intellectual property than they have in the past.

Joint Ventures/Strategic Alliances

Figure 3.4.4 Honey Nut Cheerios

There are times when businesses have opportunities within the global market that are better undertaken with a partner. Sometimes these projects are extremely large and capital-intensive or are so comprehensive that it makes sense to include multiple businesses or even governments. These large-scale, global projects usually take one of two forms: strategic alliances or joint ventures.

A **joint venture** establishes a new business that is jointly owned by two or more otherwise independent businesses. The most common joint ventures involve two companies that are equal partners in the new firm, investing money and resources while sharing control of the newly formed firm. Often, the foreign partner provides expertise on the new market, business connections and networks, and access to other in-country aspects of business such as real estate and regulatory compliance. For example, in 2015 Fiat Chrysler entered into a joint venture with Tata Motors of India to expand the production of Jeeps in India. The company created in this joint venture is Fiat India Automobiles Private Limited.

Joint ventures require a greater commitment from firms than other global strategies, because they are riskier and less flexible. Joint ventures may afford tax advantages in many countries, particularly where foreign-owned businesses are taxed at higher rates than locally owned businesses. Some countries require all business ventures to be at least partially owned by domestic business partners.

A less permanent, but equally effective way to enter the global market is through a **strategic alliance**. A strategic alliance is formed between two or more corporations, each based in their home country, for a specified period of time. Unlike a joint venture, a new company is not formed. Generally, strategic alliances are pursued when businesses find that they have gained all they can from exporting and want to expand into a new geographic market or a related business. This approach can be particularly useful when a government prohibits imports in order to protect domestic industry. The cost of a strategic alliance is usually shared equitably among the corporations involved, and it's generally the least expensive way for all concerned to form a partnership. An example of this is the alliance between General Mills and Nestlé: Honey Nut Cheerios are manufactured in bulk by General Mills in the United States and then shipped to Nestlé Europe, where they are packaged and shipped to France, Spain, and Portugal.

Advantages and Disadvantages

The greatest advantage of joint ventures and strategic alliances is the knowledge and experience of the market offered by the local partner—on everything from consumer preferences to cultural differences, language, and political/economic systems. Another advantage is that the risk of entering the market with a new product is shared by more than one firm, thereby reducing each company's exposure to potential losses.

However, these types of partnerships also have their drawbacks. When companies share their technology and industry know-how, they run the risk that the partner firm will take that technology or innovation and use it to become a competitor in the future. This was a primary concern when Boeing collaborated with Mitsubishi (it was ultimately resolved in the legal details of the partnership agreement, which both companies signed). Conflicts over control of these partnerships can also arise if the owners of the partner firms do not agree on key business decisions.

Figure 5. BMW US Manufacturing Company, South Carolina

Of all of the ways that a business can reach the global market, the most intensive approach is through foreign direct investment or FDI. **Foreign direct investment** is an investment in the form of a controlling ownership in a business enterprise in one country by an entity based in another country. FDI can take one of two forms: Greenfield ventures or mergers/acquisitions.

In a Greenfield venture, the company enters a foreign market and establishes a new subsidiary as a start-up business. A good example of this is the BMW US Manufacturing Company, a vehicle-assembly facility located in Greer, South Carolina, that is part of the BMW Group. Although it's BMW's only assembly plant in the United States, it represents a direct investment inside the United States by the German manufacturer, and it's one of the most successful Greenfield ventures in the U.S.

Businesses that are not ready to take on the challenge of establishing a new facility or subsidiary in a foreign country will usually choose either a merger or acquisition as a means of expanding their global reach. Mergers and acquisitions represent the vast majority of FDI and range from 50 percent to 80 percent of all FDI in some industries. According to *Forbes*,

> *"U.S. companies completed 116 emerging market acquisitions in the first half of 2013, up from 110 in the second half of 2012. . . . The most popular geographic targets for U.S. companies in the first half of 2013 were Brazil (25 deals), India (18 deals), South American countries excluding Brazil (15), South and East Asia (15), and Central America and Caribbean (14).[2]"*

Mergers and acquisitions aren't just carried out by U.S. companies, either—it's an incredibly pervasive global business strategy, and ownership of many well-known products and brands has long been separated from the country of origin. For example, the Chinese just bought Smithfield Foods, Stolichnaya ("Stoli") Russian vodka is actually owned by a company in the United Kingdom, Anheuser-Busch is owned by Belgian-Brazilian conglomerate InBev, and 7-Eleven is owned by the Japanese.[3]

Advantages and Disadvantages

Because the level of commitment and investment associated with FDI is so high, companies expend a great deal of time and effort scrutinizing potential opportunities. With Greenfield ventures, the amount of time it takes to build a presence in the foreign country is substantial. If a business is not already established in other global locations and lacks experience with FDI, it may be in for a series of unpleasant surprises in the form of regulations, licensing, taxes, and other "red tape"—much of which we will look at later in this module.

On the other hand, mergers and acquisitions are faster to execute than Greenfield ventures, and by merging with or acquiring an existing foreign company already in the market, outside companies can quickly take advantage of that presence. Another benefit is that a merger or acquisition involves the purchase of assets such as property, plants, and equipment that are already producing a product with a known revenue stream. The key to a successful merger or acquisition is paying the right price for the company, because, no matter how successful the business was before it was acquired (or merged), overpaying can turn a formerly profitable operation into a money pit.

1. United States Top 10 Exports. (2016). Retrieved August 17, 2016, from http://www.worldstopexports.com/united-states-top-10-exports/ ↵
2. Rapoza, K. (2013, September 13). U.S. Companies Buying up Foreign Competition. Retrieved August 18, 2016, from http://www.forbes.com/sites/kenrapoza/2013/09/15/u-s-companies-buying-up-foreign-competition/#7a6b71ef2177 ↵
3. Frohlich, T. C., & Sauter, M. B. (n.d.). Ten Classic American Brands That Are Foreign-Owned. Retrieved August 19, 2016, from http://247wallst.com/special-report/...foreign-owned/ ↵

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3.5: Global Trade Forces

What you'll learn to do: identify and describe forces that affect global trade

In this section you'll learn about the range of forces that affect global trade. These forces include everything from culture and politics to the natural environment.

Learning Objectives

- Describe the impact of political and economic forces on global trade
- Describe the impact of physical and environmental forces on global trade
- Describe the impact of tariff and nontariff restrictions on global trade

Sociocultural Differences

Culture refers to the influence of religious, family, educational, and social systems on people, how they live their lives, and the choices they make. Business always exists in an environment shaped by culture. Organizations that intend to sell products and services in different countries must be sensitive to the cultural factors at work in their target markets. Even cultural differences between different countries—or between different regions in the same country—can seem small, but businesses that ignore them risk failure in their ventures.

Culture is complex, and fully appreciating its influence takes significant time, effort, and expertise. Certain features of a culture can create an illusion of similarity, but businesses need to delve deeply to make sure they truly understand the people and environments in which they work. Even a common language does not guarantee similarity of interpretation. For example, in the U.S. we purchase "cans" of various grocery products, but the British purchase "tins." In India, where English is one of a number of officially recognized languages, "matrimonial" is used as a noun in casual conversation, referring to personal ads in newspapers seeking marriage partners.

Several dimensions of culture that require particular attention from global businesses are listed below.

Language

The importance of language differences can't be overemphasized, and there are nearly three thousand languages in the world. Language differences can be a challenge for businesses designing international marketing campaigns, product labels, brand and product names, tag lines, and so on. Finding a single brand name that works universally in terms of pronunciation, meaning, and "ownability" is a monumental challenge. Of course, correct and grammatical use of language in business communication is essential for a product, brand, or company to be viewed as credible, trustworthy, and of high quality.

The language issue becomes more complicated when a country has more than one officially recognized language. To illustrate, in Canada, national law requires that labels include both English and French. In India and China, more than two hundred different dialects are spoken. India has more than twenty officially recognized languages. Mainland China's official spoken language is Standard Chinese, and several autonomous regions have designated other additional official languages. Meanwhile in Hong Kong and Macau, Cantonese Chinese, English, and Portuguese are the official languages. Clearly language can quickly become a very challenging issue for businesses!

Finally, businesses should be attuned to what they communicate when they choose which languages to use—or not use. In Eastern Europe, for example, the long history of Soviet occupation during the Cold War has left many inhabitants with a negative perception of the Russian language. Products that carry Russian labeling may suffer accordingly.

Customs and Taboos

All cultures have their own unique sets of customs and taboos. It's important for businesses to learn about these customs and taboos so they'll know what is acceptable and unacceptable for their foreign operations. For example, in Japan, the number four is considered unlucky, and products packages containing four items are avoided by many consumers. In Middle Eastern countries where Islamic law is strictly observed, images displaying the uncovered arms or legs of the female body are considered offensive. Meanwhile in Egypt, where many women wear the headscarf or hijab in public, an increasing number of younger women are in work and educational settings where gender segregation does not exist. Businesses struggle with whether to portray women with or

without the hijab, knowing that they risk offending some of their target audience with either choice. Businesses should seek guidance from native experts familiar with local culture and customers.

Values

The role of values in society is to dictate what is acceptable or unacceptable. Values are part of the societal fabric of a culture, and they can also be expressed individually, arising from the influence of family, education, moral, and religious beliefs. Values are also learned through experiences. As a result, values can influence consumer perceptions and purchasing behavior. For example, consumers in some countries, such as the United States, tend to be individualistic and make many purchasing decisions based on their own personal preferences. In other countries, such as Japan, the well-being of the group is more highly valued, and buying decisions are more influenced by the well-being of the group, such as the family. Based on these differences in values, it is not surprising that ads featuring individuals tend to do better in countries where individualism is an important value, and ads featuring groups do better in countries where the group's well-being is a higher value.

Time and Punctuality

Different cultures have different sensitivities around time and punctuality. In some countries, being slightly late to a meeting is acceptable, whereas in other countries it's very insulting. For cultures that highly value punctuality, being on time is a sign of good planning, organization, and respect. In cultures where precise punctuality is less important, there is often a greater emphasis on relationships. The fact that a meeting happens is more important than when it happens.

While there are cultural stereotypes about time management (such as the laid-back "island time" many residents of island nations refer to), the best rule of thumb in business is to be punctual and meet deadlines as promised. You will not insult people by following this rule. Also, it's wise not to apply popular stereotypes to individual people for whom the cultural stereotype may or may not be true. You should let a person's behavior speak for itself, and always treat others with the same level of courtesy you would expect from them.

Business Norms

Business norms vary from one country to the next and may present challenges to foreigners not used to operating according to the particular norms of the host country. In business meetings in Japan, for example, it's expected that the most senior person representing an organization will lead the discussion, and more junior-level colleagues may not speak at all. The role of alcohol in business meetings varies widely by culture: In Middle Eastern cultures where alcohol is forbidden, it may be insulting to serve or even offer an alcoholic beverage. In China, many rounds of toasts are customary as part of formal dinner meetings.

Likewise, business norms around greetings and physical contact also vary. American-style handshakes have become accepted as a business norm in many cultures, but this custom is not universal. In Japan and some other Asian cultures, a respectful bow is the traditional business greeting, although the handshake is becoming more common. In Islamic cultures, contact between men and women is a sensitive issue, even in business settings. In those regions and cultures, it's best to shake hands with a woman only if she extends her hand first. Similarly, Western women may avoid causing embarrassment by shaking hands only if a hand is extended to her. In India, the namaste (a slight bow with hands brought together on the chest) remains a respectful, if traditional, business greeting particularly when interacting with women and older people.

Always seek guidance from a trusted colleague or friend who has experience in the local customs and can offer coaching on proper etiquette.

Religious Beliefs and Celebrations

As discussed earlier in this module, religious beliefs and practice can strongly influence what consumers buy (or don't buy), when and where they shop, and how they conduct business. It's important for companies to understand the influence of religion on consumer culture in the markets where they operate, so that their business activities can be appropriately sensitive. Failing to respect religious beliefs or cultures can seriously undermine the reputation of a company or brand. At the same time, businesses that are attuned to the impact of religion on culture can more easily integrate their operations and employees into the local culture.

For example, all the major world religions observe holidays that include feasting and gift giving. These festival seasons tend to be prime shopping seasons as well. Holidays originating from the prominent religion of a country or region create sensitivities about certain products: in the Hindu religion, cows are considered sacred and people refrain from eating beef. Observant Jews and Muslims consider pork unclean, and they consume only kosher or halal meats, respectively. Many religions eschew alcohol: for example, devout Sikhs, Muslims, Mormons, Buddhists, and conservative Southern Baptists all refrain from drinking.

Religious beliefs may cause sensitivities around revealing images or sexually suggestive material. Religious beliefs associated with the symbolism of different colors may create either preferences for or rejection of certain products. The link between religious practice and gender roles may affect which members of the family influence which types of buying decisions. It is important, however, for businesses not to oversimplify how decision making happens in these settings. Even if a woman, for example, is not the primary buyer, she may exercise strong influence of many consumer decisions. Here, as in other areas of cultural impact, is it crucial for businesses to educate themselves about the people and cultures they are targeting for business in order to use cultural knowledge to their advantage.

Political and Economic Differences

The **political economy** of a country refers to its political and economic systems, together. The political system includes the set of formal and informal legal institutions and structures that comprise the government or state and its sovereignty over a territory or people. As you know, political systems can differ in the way they view the role of government and the rights of citizens (compare, for example, the democratic political system of Canada with the communist system of North Korea). As you'll recall, the economic system refers to the way in which a country organizes its economy: most are command, market, or mixed economies.

The nature of a country's political economy plays a big role in whether it is attractive to foreign business and entrepreneurship. Historically, there has been a direct relationship between the degree of economic freedom in a country and its economic growth—the more freedom, the more growth, and vice versa. For decades, the Chinese government maintained an ironclad grip on all business enterprise, which effectively prevented foreign businesses from fully engaging with the Chinese market. That climate has tempered, however, and now the political economy of China is much more open to foreign investment, though it is still not as open as Europe or the U.S.

Businesses seeking global opportunities must consider other economic factors beyond a country's political economy. For one thing, they will want to target the markets and countries where people have the highest incomes and the most disposable income. The world map below shows just how much variation there is in the gross national income (GNI) per person among the nations of the world.

However, often those markets are not where *new* opportunity exists, so businesses have to pursue what economists refer to as "emerging markets." The four largest emerging and developing economies are the BRIC countries (Brazil, Russia, India, and China). One means of measuring a country's level of economic development is by its purchasing power parity (PPP), which enables economists to compare countries with very different standards of living. The PPP for a given country is determined by adjusting up or down as compared to the cost of living in the United States.

India has the world's second-largest mobile-phone user base: 996.66 million users as of September 2015. Shown here is a rooftop mobile phone tower in Bangalore.

However, there is often more to a country's economic story than its PPP or GNI. Consider India: As an emerging market, India is attracting significant attention from businesses all around the globe. It has the second-fastest-growing automotive industry in the world. According to a 2011 report, India's GDP at purchasing power parity could overtake that of the United States by 2045. During the next four decades, Indian GDP is expected to grow at an annualized average of 8 percent, making it potentially the world's fastest-growing major economy until 2050. The report highlights key growth factors: a young and rapidly growing working-age population; growth in the manufacturing sector because of rising education and engineering skill levels; and sustained growth of the consumer market driven by a rapidly growing middle class.

At the same time, surveys continue to emphasize the chasm between two contrasting pictures of India—on one side, an urban India, which boasts of large-scale space and nuclear programs, billionaires, and information technology expertise, and a rural India on the other, in which 92 million households (51 percent) earn their living by manual labor. In 2014, a report by the Indian Government Planning Commission estimated that 363 million Indians, or 29.5 percent of the total population, were living below the poverty line.

Another aspect of a country's political economy is the stability of its current government. Business activity tends to grow and thrive when a country is politically stable. When a country is politically unstable, multinational firms can still conduct business profitably,

but there are higher risks and often higher costs associated with business operations. Political instability makes a country less attractive from a business investment perspective, so foreign and domestic companies doing business there must often pay higher insurance rates, higher interest rates on business loans, and higher costs to protect the security of their employees and operations. Alternatively, in countries with stable political environments, the market and consumer behavior are more predictable, and organizations can rely on governments to enforce the rule of law.

As you can see, the desirability of a country as a potential market or investment site depends on a host of complex, interrelated factors. To further complicate matters, once a business arrives in a foreign market, it must also contend with the uncertainty of exchange rates. An **exchange rate** is the value of one country's currency relative to the value of another country's currency. For example, an exchange rate of 119 Japanese yen (JPY, ¥) to the United States dollar (US$) means that ¥119 will be exchanged for each US$1, or US$1 will be exchanged for ¥119.

Each country, using various mechanisms, manages the value of its currency. A market-based exchange rate will change whenever the value of either of the two component currencies change. A currency will tend to become more valuable whenever demand for it is greater than the available supply. It will become less valuable whenever demand is less than the available supply (this does not mean that people no longer want money, only that they prefer to hang on to their wealth in some other form, possibly another currency).

The video below will provide a complete picture of exchange rates and how they impact trade:

Clearly, exchanges rates are an important consideration for companies wanting to take their business global, since they will likely have to buy and sell even the most mundane commodities once they arrive in the foreign market. Local labor wants to be paid in its nation's currency, and if the exchange rate of that currency changes in a way that makes it more valuable, then the business's costs rise unexpectedly. Although businesses try to anticipate and plan for fluctuations in exchange rates, currency values are determined by supply and demand, and businesses are at the mercy of market forces beyond their control.

Legal Differences

Governments around the world maintain laws that regulate business practices. In some countries, these laws are more heavy-handed, and in others, the business climate is less regulated and structured. Some laws and regulations, such ones governing property rights and contracts, are designed to create a stable environment for business (both domestic and international)—by establishing the establishment and enforcement of property rights and contracts, for example. Others are designed to protect consumers and the environment, requiring businesses to adhere to responsible, safe, and ethical practices. Still other laws and

regulations privilege domestic businesses and protect or partially shield them from foreign competition. There are even laws and regulations that affect what marketers are allowed to include in marketing communications, although these are more strict in some countries than in others. And of course, some laws and regulations deal with taxation and other costs of conducting business.

Businesses must understand and conform to the legal and regulatory environments of the countries and regions in which they operate. The following is a short list of common regulatory areas that affect businesses globally:

- **Contract law** governing agreements about the supply and delivery of goods and services
- **Trademark** registration and enforcement for brand names, logos, tag lines, and so forth
- **Labeling** requirements for consumer safety, protection, and transparency
- **Patents** to enforce intellectual property rights and business rights associated with unique inventions and "ownable" business ideas
- **Decency, censorship, and freedom-of-expression** laws to which marketing communications are subject
- **Price floors, ceilings, and other regulations** regarding the prices organizations can charge for certain types of goods and services
- **Product safety**, testing, and quality-control
- **Environmental protection** and conservation regulations and permits governing acceptable and responsible business practices
- **Privacy**, including laws governing data collection, storage, use, and permissions associated with consumers and their digital identities
- **Financial reporting** and disclosure to ensure that organizations provide transparency around sound business and financial practices

In some cases, international laws and regulations designed to simplify these issues among regional allies and economic partners may also apply.

Physical and Environmental Differences

Physical and environmental factors can have a significant impact on a company's ability to do business in a foreign country. Some developing countries lack the infrastructure such as roads, railways, and port systems needed to transport goods, or they may not have adequate storage facilities. You can imagine that this would be a major barrier for businesses trying to sell fresh food or perishable goods. Add to that the limited access to electricity, clean water, and sanitation in many parts of the world, and you begin to understand some of the practical and logistical challenges of doing business globally.

A country's natural environment and the surrounding regulations aimed at protecting it may pose additional challenges. Many governments require foreign companies to undergo a complex permitting process if any of their planned activities will adversely affect the environment. Even in developing countries, minimum standards for air emissions, waste disposal, and hazardous-material handling are becoming the norm, and in places where such regulations are weak or lacking, companies often face considerable pressure from local residents and consumer groups to clean up their act or leave. While all of these challenges can make companies think twice about setting up shop in a foreign country, the growing trend of corporate social responsibility shows that more companies are devising creative, collaborative solutions to doing global business more sustainably.

Tariff and Nontariff Trade Restrictions

Although many people find it hard to imagine, not every nation welcomes the expansion of businesses into their country. When a nation seeks to restrict the flow of incoming foreign goods and services, economists refer to this as trade protectionism. Protectionism is the economic policy of restraining trade between countries through methods such as tariffs on imported goods, restrictive quotas, and a variety of other government regulations designed to foster fair competition between imports and domestically produced goods and services.

According to proponents, protectionist policies protect the businesses and workers within a country by restricting or regulating trade with foreign nations. The doctrine of protectionism contrasts with the doctrine of free trade, according to which governments reduce the barriers to trade as much as possible. There is a broad consensus among economists that the impact of protectionism on economic growth and prosperity is largely negative.

Let's take a closer look at several of the most common tools used by nations hoping to protect local industry through trade restrictions.

Import Tariffs

Import tariffs are are simply a type of tax that is levied on goods and services coming into a country. They increase the price of imported goods and services, since the businesses pass the cost of the tariff on to consumers. Tariffs benefit local producers of goods and services while generating revenue for the government. They are one of the oldest form of trade protectionism, one of the easiest to implement, and the most common subject in trade-agreement negotiations.

Nontariff Restrictions

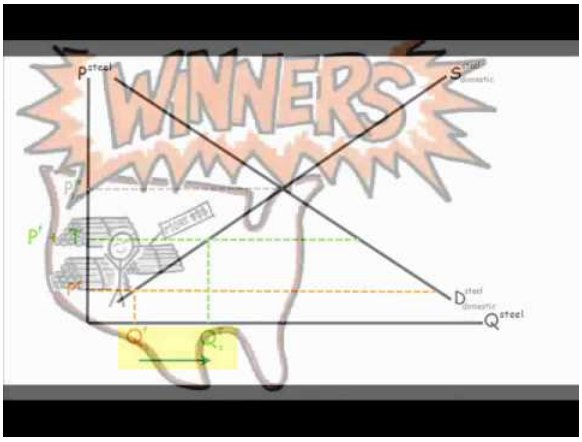
Import quotas are another means of restricting the flow of foreign goods into a local economy. An import quota is exactly what its name implies: a limit on the amount or quantity of a particular good or service that can be imported into a country. Although not as common today as they have been historically, import quotas seek to protect local businesses from a flood of cheap foreign imports. Many countries have passed "antidumping" laws aimed at foreign imports that they believe are priced below fair market value. Dumping is when a company exports a product at a price lower than the price it normally charges in its own home market. The economic impact of an import quota is similar to that of a tariff, except that the tax revenue generated by a tariff is instead paid to those who possess import licenses.

When a country is reluctant to impose quotas and tariffs, another way it can protect domestic markets is with local content requirements. **Local content requirements** are set by the government and require foreign businesses to use a certain quantity of local labor, resources, and/or suppliers in their operations. This kind of trade restriction has been a point of contention in recent trade negotiations between the United States and India. India's government has been aggressive about using local content requirements to its "Made in India" program, which it hopes will establish India as an international manufacturing hub. The United States and other countries argue that India's policies are detrimental to foreign competition. The situation is currently under review by the World Trade Organization, and given the size of the Indian economy, the rest of the world is watching.

The most extreme form of trade restriction is the **embargo**. An embargo is an official ban on trade or other commercial activity with a particular country. The reasons for a country to place an embargo on another country range from human rights violations to ideological differences to national security interests. Embargoes are considered strong diplomatic measures imposed in an effort, by the imposing country, to elicit a given national-interest result from the country on which it is imposed. Although trade and commercial activities are barred under an embargo, medical and humanitarian supplies are usually exempt. The most enduring of all trade embargoes is the United States' embargo against Cuba, which, after fifty-five years, appears to be coming to an end.

As you can see, global trade restrictions can be as narrow as a tariff on a particular imported good or as broad as an embargo, which stops the flow of goods and services between countries altogether. Since these types of restrictions are imposed by governments, businesses have no choice but to follow their rules—even when it means walking away from a lucrative opportunity.

The following video discusses the effects of different kinds of trade restrictions.



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3.6: Global Trade Agreements and Organizations

What you'll learn to do: describe global trade agreements and economic organizations that regulate and promote global trade

In this section, you'll learn about the organizations that oversee global economic cooperation and help facilitate global trade agreements.

Learning Objectives

- Describe the role of the World Bank in promoting global economic development
- Describe the role of trade agreements in global business

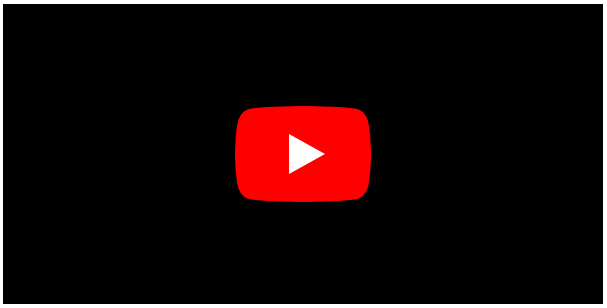
The World Trade Organization (WTO)

In the post–World War II environment, countries came to realize that a major component of achieving any degree of global peace was global cooperation—politically, economically, and socially. The intent was to level the trade playing field and reduce economic areas of disagreement, since inequality in these areas could lead to more serious conflicts. Nations agreed to work together to promote free trade and, with the help of key international organizations like the World Trade Organizations, they entered into bilateral and multilateral agreements.

GATT: How the World Trade Organization Got Its Start

Before you begin your reading on the World Trade Organization (WTO), take a few minutes to watch the following video that will give you some background on **General Agreement on Tariffs and Trade (GATT)** and explain how it grew into the WTO we know today. Remember, the world is much smaller today than when your parents and grandparents were growing up, and international trade hasn't always been the norm. After watching the video, consider how impossible world trade would be without some type of agreement among nations.

Enjoy!



As you saw in the video, what began with one agreement (GATT) eventually evolved into the WTO. In fact, GATT was the only multilateral instrument governing global trade from 1946 until 1995. Given the difficulty of trying to regulate trade among more than one hundred nations according to a single document, it's easy to see why the WTO came into existence. It became clear to the participating nations that GATT was incapable of adapting to an increasingly globalized world economy. Moreover, when the Uruguay Round of GATT negotiations was launched in September 1986, it marked the largest global effort to structure trade in history. Today, GATT still exists as the WTO's umbrella treaty for trade in goods, but it's no longer the only legally binding global-trade agreement.

What does the WTO actually do? Among its various functions, the most important are the following:

- Oversees the implementation and administration of the agreements between nations that fall under the WTO's scope of authority
- Provides a forum for negotiations and settling disputes among nations.

In recent years, the WTO has also made it a priority to assist developing nations as they come under WTO regulation. Many developing countries and emerging markets lack the experience and technical expertise needed to deal with large and very comprehensive trade agreements. The WTO provides them with critical training and support, thereby ensuring that the WTO is inclusive and equitable toward both the wealthiest and the poorest nations in the world.

Part of the nondiscrimination mandate of the WTO is most-favored-nation (MFN) status. Most-favored-nation status requires that a WTO member must apply the same terms and conditions to trade with any and all other WTO members. In other words if a country grants another country (even a non-WTO member) a special favor, then every other WTO member must get the same treatment. You probably experienced a version of most-favored-nation status as a child, when an adult told you that if you were going to take gum or candy to class, you had to bring enough for everyone. In other words you couldn't just give gum or candy to your best friends, and if you didn't have enough for everyone in the class, then nobody got any. That, in effect, is how most-favored-nation status works.

One of the other key elements to the success of the WTO is its transparency requirement. WTO members are required to publish their trade regulations and follow a system that allows external parties to review and evaluate any administrative decisions and their impact on trade regulations. When a WTO nation changes its trade policies, those changes must be reported to the WTO.

Overall, the WTO's mission is to improve the stability and predictability of global trade. As a result, it tends to support free-trade, as opposed to protectionist, policies, and strongly discourages the use of quotas and other such restrictions on imports.

Whether or not the WTO is doing its duty and accomplishing its mission is a matter of ongoing debate. Nonetheless, the WTO currently has 104 members and twenty observer governments. WTO member states account for almost 97 percent of global trade and 98 percent of global GDP. Once the twenty observer governments become members, it is possible that the WTO will oversee the entire world economy. What began in 1947 in Geneva, with twenty-three nations focused solely on tariff reduction, has grown into a truly global organization that deals with agriculture, labor standards, environmental issues, competition, and intellectual property rights.

The World Bank

World Bank Group president Jim Yong Kim visits an integrated child development services and skills center in Delhi, India.

Created in 1944 at the Bretton Woods Conference in New Hampshire, the **World Bank** is an international financial institution that provides loans for capital programs to developing countries. It comprises two institutions: the International Bank for Reconstruction and Development (IBRD), and the International Development Association (IDA). Originally, the IBRD was tasked with supporting post-war reconstruction, but it has evolved to include the present-day mandate to alleviate poverty worldwide. The World Bank is a component of the World Bank Group, which is part of the United Nations system. The World Bank is comprised of 189 member countries represented by a board of governors. Although headquartered in Washington DC, the World Bank has a presence in almost every nation in the world.

The World Bank has set two goals to achieve by 2030:

1. End extreme poverty by decreasing the percentage of the world's population that live on less than US$1.90 per day to no more than 3 percent
2. Promote shared prosperity by fostering the income growth of the bottom 40 percent in every country

The World Bank's primary function is providing low-interest loans and grants to developing countries. It tends to fund projects focused on education, infrastructure, natural-resource management, and public health. In many instances, the World Bank provides technical assistance as well as research and policy advice to developing nations. One of the projects currently underway is the Education Sector Support Project for the Republic of the Congo. The primary objective of this project is to improve education outcomes for primary- and secondary-school children by providing quality education in an appropriate teaching and learning environment. Other World Bank projects are aimed at improving basic infrastructure, such as building and maintaining safe water supplies and sanitary sewer systems in Africa and parts of Asia. For developing nations, many of these improvements would be impossible without the World Bank's help. Although the World Bank has come under fire in the past for budget overruns and poor project oversight, its role in promoting economic development has been undeniable.

The following video shows how a World Bank project works:

The International Monetary Fund (IMF)

The **International Monetary Fund (IMF)** is an international organization headquartered in Washington, D.C., comprised of 189 member countries. The IMF works to foster global growth and economic stability by providing policy, advice, and financing to its members. It also works with developing nations to help them reduce poverty and achieve macroeconomic stability. Formed in 1944 at the Bretton Woods Conference in New Hampshire, it came into formal existence in 1945 with twenty-nine member countries and the goal of reconstructing the international payment system. It now plays a central role in the management of balance-of-payments difficulties and international financial crises.

IMF member countries contribute funds to a pool, from which they can borrow if they are experiencing balance-of-payments problems. The rationale for this arrangement is that private international capital markets function imperfectly, and many countries have limited access to financial markets. Without access to IMF financing, many countries can only correct large external payment imbalances through drastic measures that can have adverse effects on their own economies and the world's. The IMF provides alternate sources of financing to countries in need that would not otherwise be available to them.

When the IMF was founded, its primary functions were to provide short-term capital to aid the balance of payments and to oversee fixed-exchange-rate arrangements between countries, thus helping national governments manage their exchange rates and prioritize economic growth. This assistance was meant to prevent the spread of international economic crises. The IMF was also formed to help put the pieces of the international economy back together after the Great Depression and World War II. In addition, it also sought to provide capital investments for economic growth and infrastructure projects.

The IMF's role was fundamentally altered by floating exchange rates post-1971. At that point the organization began examining the economic policies of its loan recipients to determine whether a shortage of capital was due to economic fluctuations or economic policy. The IMF also researched what types of government policy would ensure economic recovery. The current challenge is to help countries implement economic policies that reduce the frequency of crises among the emerging-market countries, especially the middle-income countries that are vulnerable to massive capital outflows. In order to meet this challenge, the IMF's activities have expanded beyond the oversight of exchange rates to surveillance of the overall macroeconomic performance of its member countries. Today it plays an active role in shaping and managing economic policy around the world.

The following video gives a good overview of the IMF and its role in promoting global trade.

Trade Agreements

So far you have seen how international organizations such as the WTO, IMF, and World Bank support global trade, but this is only part of the story. Where global trade really gets a boost is from trade agreements (also called trade blocs). This where the term "global economic integration" gets its legs— from the process of modifying barriers among and between nations to create a more fully integrated global economy. Trade agreements vary in the amount of free trade they allow among members and with nonmembers; each has a unique level of economic integration. We will look at four: regional trade agreement (RTA) (also called a "free trade area"), customs unions, common markets, and economic unions.

Regional trade agreements are reciprocal trade agreements between two or more partners (nations). Almost all countries are part of at least one RTA. Under an RTA, countries "huddle together," forming an international community that facilitates the movement of goods and services between them. For example, the North American Free Trade Agreement (NAFTA) enacted between Canada, the U.S., and Mexico facilitates trade among these countries through tariff reductions and elimination. The Association of Southeast Asian Nations (ASEAN), shown below, provides for the free exchange of trade, service, labor, and capital across ten independent member nations to provide a balance of power to China and Japan. The Central American Free Trade Agreement (CAFTA) (Costa Rica, Dominican Republic, Guatemala, Honduras, Nicaragua, and El Salvador) eliminated tariffs on more than 80 percent of U.S. exports and opened U.S. trade restrictions for Central American sugar, textiles, and apparel imports, thereby reducing costs on these products for American consumers[1].

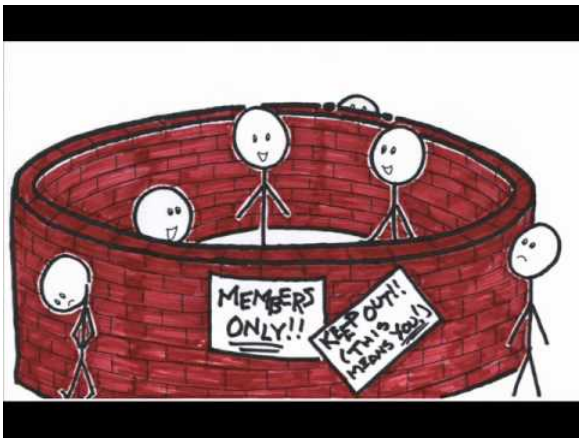
The Association of Southeast Asian Nations (ASEAN) as of 2015.

Customs unions are arrangements among countries whereby the parties agree to allow free trade on products *within* the customs union, and they agree to a *common external tariff* (CET) on imports from the rest of the world. It is this CET that distinguishes a customs union from a regional trade agreement. It is important to note that although *trade* is unrestricted within the union, customs unions do not allow free movement of capital and labor among member countries. An example is the customs union of Russia, Belarus, and Kazakhstan, which was formed in 2010. These countries eliminated trade barriers among themselves but have also agreed to some common policies for dealing with nonmember countries.

Common markets are similar to customs unions in that they eliminate internal barriers between members and adopt common external barriers against nonmembers. This difference is that common markets also allow free movement of resources (e.g., labor) among member countries. An example of a common market is the Economic Community of West African States (ECOWAS), comprised of Benin, Burkina Faso, Cape Verde, Gambia, Ghana, Guinea, guinea-Bissau, Ivory Coast, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo.

An even more economically integrated arrangement is the **economic union**. Economic unions eliminate internal barriers, adopt common external barriers, permit free movement of resources (e.g., labor), AND adopt a common set of economic policies. The best-known example of an economic union is the European Union (EU). EU members all use the same currency, follow one monetary policy, and trade with one another without paying tariffs.

The following video further explains and compares the different types of trade agreements:



1. USTR, CAFTA-DR Dominican Republic-Central America FTA ↵

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3.7: Ethical Challenges in the Global Environment

What you'll learn to do: describe ethical challenges that businesses face in a global environment

The ethical landscape of international business is cloudy, and the diverse nature of cultural, political, and legal systems around the world often makes the line between ethical and unethical business practices difficult to negotiate. In this section you will learn about some of the ethical challenges and issues that businesses face in global markets.

Learning Objectives

- Explain why forms of corruption such as bribery are so widespread and difficult to regulate
- Summarize the key parts of the Foreign Corrupt Practices Act

Labor Abuses

The term **sweatshop** refers to a factory that is guilty of some sort of labor abuse or violation, such as unsafe working conditions, employment of children, mandatory overtime, payment of less than the minimum wage, unsafe working conditions, abusive discipline, sexual harassment, or violation of labor laws and regulations. The U.S. Government Accounting Office has chosen to define a sweatshop as any manufacturing facility that is guilty of two or more of the above types of labor abuses. However, it is important to understand that the term sweatshop is not just a legally defined term but a word that is used broadly and has entered the general lexicon.

Rana Plaza

Garment factory collapse, Rana Plaza, Bangladesh.

On April 24, 2013, at Rana Plaza on the outskirts of Dhaka, Bangladesh, a building containing apparel factories collapsed, trapping and killing more than 1,100 employees. It was not only the worst industrial disaster in the history of the garment industry, it was also the world's most fatal industrial building collapse. News reports soon emerged that the factory owners had ignored ominous warning signs, such as visible cracks in the wall, and had illegally added several stories to the top of the building, creating a weight the building could not bear. Many of the factories operating in the building were producing apparel for well-known Western brands, such as Walmart, Joe Fresh, and Mango.

Rescue workers struggled for more than a week to reach trapped survivors, while hospitals tended to the more than 2,500 workers who had escaped, many with severe injuries. Survivors told heart-rending tales of having lost mothers and sisters who had worked in the same factories. The deaths of so many innocent workers created a firestorm of controversy in Bangladesh and around the world. Accusations and recriminations were leveled at corporations and government officials. A period of intense and profound soul-searching ensued for the global fashion companies that relied on outsourced factory labor in Bangladesh. Within a few months, two major initiatives were announced, one American and one European, to increase safety and accountability in Bangladeshi factories.

How did this situation arise?

Thanks to international efforts to lower import tariffs, such as those instituted by GATT in 1947 and by the WTO in 1995, an outsourcing movement was born, and many companies saw the opportunity to lower their production costs by moving them overseas. Fashion and apparel companies were among the first to take advantage of the benefits of outsourcing—namely, gaining access to cheap foreign labor markets. Throughout the period from 1970 to the present, employment in American apparel factories dropped sharply as companies moved production to countries like Indonesia, Vietnam, China, Mexico, and the Dominican Republic.

The outsourcing movement was accompanied by increasing reports of sweatshop abuses. As a result, a number of nongovernmental organizations (NGOs), such as the National Labor Committee, became involved in anti-sweatshop activities. Throughout the 1990s, a number of sweatshop-related abuses came to light in factories used by American brands. Several of these involved the island of Saipan, a small American protectorate in the Pacific. A number of factory owners discovered that since Saipan is technically American territory, clothing produced in Saipan could enter the United States duty-free and carry the label "Made in America." Since Saipan is much closer to Vietnam and the Philippines than to the United States, a number of these factories

recruited Vietnamese and Filipino natives as factory workers. Upon their arrival in Saipan, however, some of these workers were exposed to flagrant human rights abuses and, in the worst of cases, outright slavery. In one notorious case, workers were literally imprisoned in the factory and forced to work without pay. Eventually, these abuses were revealed and U.S. prosecutors filed charges against factory owners, some of whom were sentenced to substantial prison sentences.

In the early 1990s, one of America's most prominent footwear brands, Nike, also came under attack as reports emerged from Indonesia and Vietnam of worker abuse. In Vietnam, a young female factory employee was working on basketball shoes when her machine exploded and sent a bolt through her heart. At first, Nike refused to accept responsibility, pointing out that Nike had never manufactured its own footwear and apparel. Nike's contracts with its sourcing factories required the factories to obey labor regulations and, in Nike's view, this meant that any abuses were the factories' responsibility. However, by 1998, the continuing negative publicity obliged Nike to reverse its course by instituting a strict code of conduct for its factories.

By 2000, as a result of continued scrutiny from various watchdog organizations like the Worker Rights Consortium, the National Labor Committee, and other international groups such as the Clean Clothes Campaign, most large apparel brands developed and publicized their own internal codes of conduct for suppliers. Such codes of conduct were contractually imposed on all suppliers and required that factories comply with all local labor laws, refrain from employing children, and maintain safety programs. In addition, most brands began to require that factories make themselves available for inspections to make sure that they were complying with the standards set forth in the codes of conduct. A number of inspection companies sprang up to service the needs of the corporations and groups of young inspectors soon scanned the globe, moving from factory to factory, checking them for fire violations, reviewing records to make sure that rules on overtime were respected, and so forth.

Despite all these efforts, reports of violations continued to be heard. The American consumer seemed to have wearied of the sweatshop issue to some extent, and companies like Walmart and Nike, which had often been accused of sweatshop abuses, saw their sales and stock valuations continue to rise. Many companies began to focus more on environmentalism and anti–global-warming issues, and a number of brands began to require that their supply factories obtain some sort of environmental certification, such as the Bluesign certification that was established in Germany under the auspices of SGS S.A., the world's largest inspection company. Then, in 2012 and 2013, a horrific series of accidents reminded the world's consumers that the sweatshop issue was still with us.

In 2012, a fire broke out at an apparel factory in Pakistan, killing some 270 Pakistani workers. Among the Western companies sourcing from that factory were the UK retailer Tesco and the German apparel brand Kix. Kix's offer to compensate the victims' families $2,000 per fatality was viewed by many Pakistanis as insulting. Then, just a few months later, at the Tazreen Fashions factory in Dhaka, Bangladesh, another 112 factory workers perished in a fire. Again, it was discovered that well-known Western brands such as Walmart, Disney, and the Gap had sourced products from the factory. The world's attention was squarely focused on Pakistan and Bangladesh when the building collapse at Rana Plaza in Bangladesh became the worst industrial catastrophe in the history of apparel manufacturing.

Corruption

In the following video, Joseph R. DesJardins discusses the concept of ethics and asks whether international standards of behavior are possible. What do you think?

When a large corporation decides to enter a foreign market, it must usually secure a number of licenses, permits, registrations, or other government approvals. Certain types of business may be even be impossible or illegal unless the corporation is first able to obtain a change or adjustment to the nation's laws or regulations. Since the power to authorize the foreign corporation's activities is vested in the hands of local politicians and officials, and since corporations have access to large financial resources, it should not be surprising that some corporate executives resort to financial incentives to influence foreign officials. While certain financial incentives, such as promises to invest in local infrastructure, may be legitimate, any form of direct payment to the foreign official that is intended to influence that official's public decisions will cross the line into *bribery*.

Bribery is one of the archetypal examples of a corporation engaged in unethical behavior. A number of problems can be attributed to business bribery. First, it is obviously illegal—all countries have laws that prohibit the bribery of government officials—so the foreign company engaging in bribery exposes its directors, executives, and employees to grave legal risks. Second, the rules and regulations that are circumvented by bribery often have a legitimate public purpose, so the corporation may be subverting local social interests and/or harming local competitors. Third, the giving of bribes may foment a culture of corruption in the foreign country, which can prove difficult to eradicate. Fourth, in light of laws such as the U.S. Foreign Corrupt Practices Act (FCPA) and the Organization of Economic Cooperation and Development (OECD) Convention on Anti-Bribery (discussed in greater detail below), bribery is illegal not only in the target country, but also in the corporation's home country. Fifth, a corporation that is formally accused or convicted of illicit behavior may suffer a serious public relations backlash.

Despite these considerable disincentives, experts report that worldwide business corruption shows little signs of abating. Transparency International (TI), a leading anticorruption organization based in Berlin, estimates that one in four people worldwide paid a bribe in 2009. It appears that the total number of bribes continues to increase annually. The World Economic Forum calculated the cost of corruption in 2011 at more than five percent of global GDP (US$2.6 trillion) with more than $1 trillion paid in bribes each year.

Governments and intergovernmental organizations have redoubled their efforts to combat the perceived increase in international business corruption. Globalization, which accelerated in the final decades of the twentieth century, is often cited by specialists as contributing to the spread of corruption. Corporations and businesses in every nation have become increasingly dependent on global networks of suppliers, partners, customers, and governments. The increased interaction between parties in different countries has multiplied the opportunities for parties to seek advantage from illicit incentives and payoffs. Although outright bribery is clearly unethical and illegal, there is great deal of behavior that falls into a gray zone that can be difficult to analyze according to a single global standard. When does a business gift become a bribe? What level of business entertainment is "right" or "wrong"? Over the past two decades, governments and regulators have sought to clearly define the types of behavior that are considered unethical and illegal.

Another factor that has heightened the sense of urgency among regulators is the magnitude of recent cases of corruption (several of which are described in greater detail below). The cost to shareholders as well as stakeholders and society has proven enormous. Governments and international organizations have ramped up their enforcement of anticorruption laws and sought increasingly

severe penalties, sometimes imposing fines amounting to hundreds of millions of dollars. Largely as a result of these efforts, most multinational corporations have developed internal policies to ensure compliance with anticorruption legislation.

The following are recent examples of large-scale corruption in international business.

Walmart in mexico

According to a report issued by the Mexican Employers Association in 2011, companies operating in Mexico spend more than 10 percent of their revenue on corrupt acts. One of the most well-known cases was the Walmart scandal that came to light in September 2005 and resulted in the company's stock value dropping by as much as $4.5 billion. Evidence unearthed by internal and external investigations revealed a widespread use of bribes, alleged to total more than $24 million. The bribes were paid to facilitate the construction of Walmart stores throughout Mexico. The country is a huge market for Walmart—one in every five Walmart stores is in Mexico. As of October 2014, the investigation continued, having implicated Walmart senior level management of complicity or awareness.

glaxosmithkline in china

In September 2013, China's Xinhua news agency reported that a police investigation into bribes paid by drug manufacturer GlaxoSmithKline (GSK) indicated that the bribes were organized and paid by GSK China and not by individuals operating on their own prerogative as had been reported by the company initially. Police also alleged that the corporate parent merely went through the motions of an internal audit process, indicating a knowledge and acceptance of the bribery. This very recent case suggests that the Chinese government's widely publicized arrests and convictions for bribery have not yet served as a sufficient deterrent to corrupt practices by foreign corporations.

alcatel in costa rica

In January 2010, mobile-device manufacturer Alcatel agreed to pay Costa Rica $10 million in reparations for social damage caused by Alcatel's payment of $2.5 million in bribes to get a contract to provide mobile phone services in that country. This case is notable for its application of the concept of social damage and the resulting order of compensation to the citizens of Costa Rica.

Anticorruption Laws and Regulations

The first major international anticorruption law was the United States' **Foreign Corrupt Practices Act (FCPA)**, adopted in 1977. The FCPA criminalized bribery of foreign public officials by American business enterprises. Initially, the FCPA was not well received. Few other countries followed suit and US companies complained that the FCPA shut them out of the competition for billions of dollars' worth of overseas business contracts. Slowly, however, the push for concerted anticorruption measures gathered momentum, and intergovernmental institutions such as the OECD, the African Union, and the United Nations eventually adopted anticorruption conventions. Further support for a global anticorruption agenda was provided by lending institutions such as the World Bank, by NGOs such as Transparency International, and by the rapidly evolving corporate social responsibility movement. Notable among these efforts was the Communist Party of China's promulgation of a code of ethics to fight the widespread corruption within the Communist Party of China.

The FCPA applies only to bribes paid (or offered) to foreign government officials to obtain or retain business or to develop an unfair competitive advantage. The concepts of *bribe* and *foreign government official* can be interpreted broadly. While companies

and executives charged with FCPA violations have often sought to characterize their payments as business "gifts," this has not shielded them from liability when there was evidence that the payments were intended as a means of obtaining illicit objectives. However, where payments have been characterized as "facilitation" or "lubrication" payments, meaning that they merely created an incentive for an official to promptly execute legal actions, such as mandatory customs inspections, the payments have been allowed. In numerous countries, the state owns all or part of commercial enterprises, so a great number of business executives could be classified as foreign government officials.

In 1997, the **Organization for Economic Cooperation and Development (OECD)** established legally binding standards for defining bribery in international business transactions. Similar to the FCPA, the OECD Anti-Bribery Convention focuses on the bribery of public officials. Like the FCPA, the OECD also potentially creates the opportunity for companies to circumvent the regulations by hiring consultants or agents. Notably excluded from the scope of the OECD Convention is a prohibition against bribing private parties. Despite such loopholes, the OECD Convention was an important step in the right direction. By 2012, forty-three countries had ratified the agreement and begun its implementation.

Corruption from a Cross-Cultural Perspective

Compliance with anticorruption legislation raises complex ethical dilemmas for corporations. It remains difficult to regulate ethical behavior when social and cultural norms vary significantly from country to country. Acts that are considered unethical in one country may represent a traditional way of doing business in another. One legal scholar explains the difference as follows:

> *"A common misconception, held in both Western and developing countries, and even among many researchers on corruption, is to confuse what is corrupt with what is legal. Laws are defined by values, as are ethical norms, but the two are not equivalent.*[1]"

The West tends to be universalist in its outlook: That is, every society works, or should work, essentially the same way. Its business practices, for example, should be based on a market system that is characterized by transparency and regulated by laws that apply to everyone. A country that fails to conform to this model is seen as underdeveloped or dysfunctional. It follows from this view that that corruption is basically the same in Sweden as in Sudan.

The reality, however, is that different cultures use radically different systems to get things done. Whereas Western cultures are primarily rule based, most of the world's cultures are relationship based. Westerners tend to trust the system, while non-Westerners are cemented by personal honor, filial duty, friendship, or long-term mutual obligation. Loyalty to cronies is suspect behavior in the West but represents high moral character in much of the world.

What is corrupt in the West may be acceptable elsewhere. The classic example of the purchasing agent illustrates this point. The Western purchasing agent is expected to award contracts based on the quality of bids and transparently available financial information about the bidders. An agent who favors personal friends is viewed as corrupt, because cronyism subverts this transparency-based system. It creates a conflict of interest: A choice that is good for the agent and his or her cronies may not be good for the company.

In much of the world, however, cronyism is a foundation for trust. A purchasing agent does business with friends because friends can be trusted. He or she may not even ask to see the company financials, since this could insult the other's honor. It is assumed that cronies will follow through on the deal, not because they fear a lawsuit, but because they do not wish to sacrifice a valuable relationship in an economy where relationships are the key to business. In such a system it is in the company's interest for the agent to do business with friends, and cronyism may therefore present no conflict of interest.

1. Sharon Eiher, "Corruption in International Business: The Challenge of Cultural and Legal Diversity," Wichita, KS: Friends University, accessed October 29, 2013, www.ashgate.com/pdf/SamplePag...siness_Ch1.pdf. ↵

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3.8: Putting it Together- Global Environment

Synthesis

Remember the humble banana we talked about at the start of this module? Now you know at least some of what it takes to get bananas from Brazil to your local grocery store: trade agreements, currency exchange rates, compliance with federal laws, bribery and possible corruption, national comparative advantages, tariffs, trade restrictions, cultural differences, and more. Those are just a few of the things that had to fall into place to get those bananas into your local market and ultimately into a banana split served at the local ice cream shop!

What is the future of globalization? Take a look at the following video for some ideas . . .

Summary

This module covered the global environment of business. Below is a summary of the topics covered in this module.

Globalization

Why do countries trade? Shouldn't a strong country such as the United States produce all of the computers, television sets, automobiles, cameras, and VCRs it wants rather than import such products from Japan? Why do the Japanese and other countries buy wheat, corn, chemical products, aircraft, manufactured goods, and informational services from the United States? Because countries have different natural, human, and capital resources and different ways of combining these resources, they are not equally efficient at producing the goods and services that their residents demand. The decision to produce any good or service has an **opportunity cost**, which is the amount of another good or service that might otherwise have been produced. Given a choice of producing one good or another, it is more efficient to produce the good with the lower opportunity cost, using the increased production of that good to trade for the good with the higher opportunity cost.

Measuring Global Trade

A nation has a comparative advantage at producing something if it can produce it at a lower cost than another. A competitive advantage is a term describing attributes that allows a nation to outperform competing nations. These attributes may include access to natural resources, such as high-grade ores or inexpensive power, highly skilled personnel, geographic location, high entry barriers, etc.

Global Business Strategies

The main strategies that companies use to enter the global market are exporting/importing, outsourcing/offshoring, licensing and franchising, joint ventures/strategic alliances, and foreign direct investment (FDI). Each has different advantages and disadvantages that must be weighed carefully.

Global Trade Forces

Firms desiring to enter international business many forces and barriers. Common barriers to effective global business are cultural, social, and political barriers, and tariffs and trade restrictions.

Ethical Challenges in the Global Environment

Culture plays a big role in shaping and defining ethical behavior. As a result, what may be considered ethical in one country may be seen as unethical in another. In a global business context, such ethical challenges often arise in the form of corruption and labor abuse.

Global Trade Agreements and Organizations

The goal of the GATT is to make trade freer, and thus the promises countries make must involve reductions in trade barriers. The WTO's main purpose is to monitor the trade liberalization agreements reached by GATT-member countries in the Uruguay Round. The most important "power" of the WTO is its ability to adjudicate disputes between member countries regarding compliance with the agreements. The IMF's key roles are the following: promote international monetary cooperation; facilitate the expansion and balanced growth of international trade; promote exchange stability; and assist in the establishment of a multilateral system of payments. The World Bank has one central purpose: to promote economic and social progress in developing countries by helping raise productivity so that their people can live a better and fuller life.

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CHAPTER OVERVIEW

4: Financial Markets and System

4.1: Why It Matters- Financial Markets and System
4.2: Market
4.3: Role of Banks
4.4: Financial Markets and Business
4.5: Putting It Together- Financial Markets and System

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4.1: Why It Matters- Financial Markets and System

Why explain the institutions and markets that comprise the financial system, and explain how they impact the economy and the money supply?

All of the words in the word-cloud image, shown at the left, refer to the same thing: **money**.

Have you heard the saying “Money makes the world go around”? In many ways money drives almost all of our endeavors. Consider why you are here taking this course. You are obtaining knowledge in order to get a better job, to obtain a degree or other credential, or to be more informed in your daily life so that you can support yourself and provide for those you love. Even if you are interested in charitable endeavors to improve the human condition, such efforts to support a cause will require money—even indirectly. Understanding how money functions—the different forms it takes and where it goes—is the first step in being able to comprehend our financial system.

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4.2: Market

What you'll learn to do: explain what money is and what makes it useful

When we think of money, the paper bills in our wallet or the coins that are in our pockets come to mind. But money is much more than that, and how we define money determines where and how we use it to obtain the goods and services that businesses offer the consumer. In this section we'll look at what money is, why it's useful, and what may be the future of money.

Learning Objectives

- Discuss the advantages of using money versus barter
- Discuss alternatives to traditional currency used today

What Is Money?

Money is really anything that people use to pay for goods and services and to pay people for their work. Historically, money has taken different forms in different cultures—everything from salt, stones, and beads to gold, silver, and copper coins and, more recently, virtual currency has been used. Regardless of the form it takes, money needs to be widely accepted by both buyers and sellers in order to be useful.

Barter and the Double Coincidence of Wants

To understand the usefulness of money, we must consider what the world would be like without money. How would people exchange goods and services? Economies without money typically engage in the barter system. **Barter**—literally trading one good or service for another—is highly inefficient for trying to coordinate the trades in a modern advanced economy. In an economy without money, an exchange between two people would involve a double coincidence of wants, a situation in which two people each want some good or service that the other person can provide. For example, if a hairstylist wants a pair of shoes, she must find a shoemaker who has a pair of shoes in the correct size and who is willing to exchange the shoes for a certain number of hairdos. Such a trade is likely to be difficult to arrange. Think about the complexity of such trades in a modern economy, with its extensive division of labor that involves thousands upon thousands of different jobs and goods.

Another problem with the barter system is that it doesn't allow people to easily enter into future contracts for the purchase of many goods and services. For example, if the goods are perishable, it may be difficult to exchange them for other goods in the future. Imagine a farmer wanting to buy a tractor in six months using a fresh crop of strawberries. Also, while the barter system might work all right in small economies, it will keep those economies from growing. The time that individuals might otherwise spend producing goods and services and enjoying leisure time is spent bartering.

Functions of Money

Money solves the problems created by the barter system. First, money serves as a **medium of exchange**, which means that money acts as an intermediary between the buyer and the seller. Instead of exchanging hairdos for shoes, the hairstylist now exchanges hairdos for money. This money is then used to buy shoes. To serve as a medium of exchange, money must be very widely accepted as a method of payment in the markets for goods, labor, and financial capital.

In addition, money needs to have the following properties:

1. It must be *divisible*—that is, easily divided into usable quantities or fractions. A $5 bill, for example, is equal to five $1 bills. If something costs $3, you don't have to tear up a $5 bill; you can pay with three $1 bills.
2. It must be *portable*—easy to carry; it can't be too heavy or bulky.
3. It must be *durable*. It can't fall apart or wear out after a few uses.
4. It must be *difficult* to *counterfeit*. It won't have much value if people can make their own.

Second, money must serve as a **store of value**. Consider the barter between the hairstylist and shoemaker again. The shoemaker risks having his shoes go out of style, especially if he keeps them in a warehouse for future use—their value will decrease with each season. Shoes are not a good store of value. Holding money is a much easier way of storing value. You know that you don't need to spend it immediately, because it will still hold its value the next day or the next year. This function of money doesn't

require that money is a *perfect* store of value. In an economy with inflation, money loses some buying power each year, but it remains money.

Third, money serves as a **unit of account**, which means that it's the ruler by which other values are measured. For example, a hairstylist may charge $30 to style someone's hair. That $30 can buy two shirts (but probably not a pair of shoes). Money acts as a common denominator, an accounting method that simplifies thinking about trade-offs.

So money serves all of these functions—it's a medium of exchange, store of value, and unit of account.

Uninscribed electrum coin from Lydia, 6th century BCE.

Commodity versus Fiat Money

Commodity money consists of objects that have value in themselves as well as value in their use as money. Gold, for example, has been used throughout the ages as money, although today it is not used as money but rather is valued for its other attributes. Gold is a good conductor of electricity and is used in the electronics and aerospace industry. Gold is also used in the manufacturing of energy efficient reflective glass for skyscrapers and is used in the medical industry as well. Of course, gold also has value because of its beauty and malleability in the creation of jewelry.

As commodity money, gold has historically served its purpose as a medium of exchange, a store of value, and as a unit of account. Commodity-backed currencies are dollar bills or other currencies with values backed up by gold or another commodity held at a bank. During much of its history, the money supply in the United States was backed by gold and silver. Interestingly, antique dollars dated as late as 1957 have "Silver Certificate" printed above the portrait of George Washington, as shown below. This meant that the holder could take the bill to the appropriate bank and exchange it for a dollar's worth of silver.

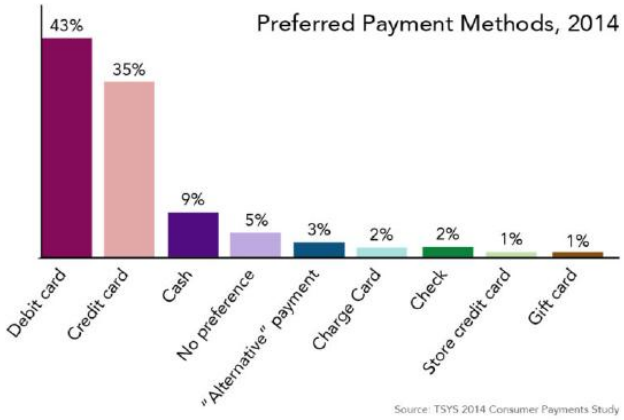
A Silver Certificate and a Modern U.S. Bill. Until 1958, silver certificates were commodity-backed money—backed by silver, as indicated by the words "Silver Certificate" printed on the bill. Today, U.S. bills are backed by the Federal Reserve, but as fiat money.

As economies grew and became more global in nature, the use of commodity monies became more cumbersome. Countries moved toward the use of fiat money. **Fiat money** is legal tender whose value is backed by the government that issued it. The United States' paper money—like the dollar bill, for instance—carries this statement: "This note is legal tender for all debts, public and private." In other words, by government decree, if you owe a debt, then legally speaking, you can pay that debt with the U.S. currency, even though it's not backed by a commodity. The only backing of our money is widespread faith and trust that the currency has value—and nothing more.

The following video discusses some additional characteristics of money:

Alternatives to Traditional Currency

Whoever said that “cash is king” hasn’t been paying attention to how consumers choose to pay for their purchases, particularly in developed economies. Take a look at the following chart:



Is a cashless future in the cards? A 2013 MasterCard report found that, in 2011, cashless payments made up 66 percent of global spending. Consumers in Belgium, France, and Canada used cash the least in 2011, as cashless payments made up 93 percent, 92 percent, and 90 percent of payments respectively. In the United States, 80 percent of payments were cashless in 2011.

Consumers expect to make fewer cash payments in the future, while also cutting back on credit- and debit-card use in favor of other forms of payments. In an Accenture survey, 66 percent of North Americans said they used cash daily or weekly in 2014 while only 54 percent expected to do so by 2020.

Money is an abstraction built on trust. As such, alternatives to the most tangible form of money—currency or cash—and its replacement with cashless payments have become possible. In this new emerging landscape, no transaction requires money in the form of notes and coins, and value can be exchanged through the transfer of information between transacting parties. There have been multiple waves of such alternatives.

Established alternatives to cash include checks, credit cards, debit cards, and prepaid debit cards. More recently, innovative options have sprung up that not only threaten to imperil the ubiquity of cash but also upend the traditional payment ecosystem. These include smartphone-enabled credit-card acquirers, such as Square, and Automated Clearing House or ACH acquirers, such as PayPal and Dwolla. And then there are even more ambitious alternatives to cash that have been proposed, such as Bitcoin, a Web-based cryptocurrency.

Unlike traditional money, such alternatives do not derive their value from government fiat—i.e., the government has not established their legitimacy or value. Each of these alternatives has an evolved network within which it is uniformly accepted as a means of payment; the more established alternatives, of course, have the widest networks.[1]

We will examine this trend further by taking a look at Bitcoin and Mobile Commerce.

Bitcoin

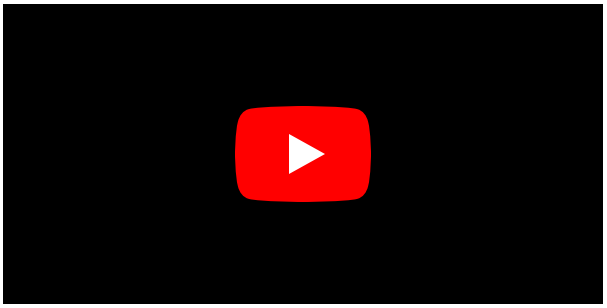
Today, there are more than *seven hundred* digital currencies in existence. Entering the marketplace is undertaken by so many due to the low cost of entry and the profit opportunity. In 2014, the European Banking Authority defined **virtual currency** as "a digital representation of value that is neither issued by a central bank nor a public authority, nor necessarily attached to a fiat currency, but is accepted by natural or legal persons as a means of payment and can be transferred, stored, or traded electronically." The first and most widely known instance of such digital, virtual, or cryptocurrency is Bitcoin.

Bitcoin Background

Bitcoin, a peer-to-peer digital currency or cryptocurrency, operates without the involvement of traditional financial institutions, and it provides a direct digital alternative to physical currencies. Bitcoin transactions take place online directly between the buyer and seller, with each transaction having a unique encryption. Transactions are recorded on a decentralized public ledger available for network users to verify valid transactions. Special users on the network ("miners") oversee this verification process. After verifying a block of transactions, miners are paid with twenty-five newly generated Bitcoins and the transactions are processed and approved; this is how the total number of Bitcoins grows. The number in circulation as of January 2015 was approximately 13.7 million, with the maximum set at 21 million. As of April 2015, their total value was $3 to $4 billion.

Governments worldwide generally do not yet see it and other digital currencies as a destabilizing "threat," and some scholars have argued that it may best be seen as a speculative investment. Bitcoin has certainly had its ups and downs: As of April 1, 2015, its value stood at $242 per Bitcoin, after a January 14 low of $177 and a March 11 high of $296. The currency has also had a long run of troubles with hackers and fraud, most spectacularly in 2014 when the exchange Mt. Gox declared bankruptcy after Bitcoins worth $460 million at the time were apparently stolen. Bitcoin's decentralized model and degree of anonymity have also raised concerns over its use in illegal money transfers, fueling potential illicit commerce across the "dark Web" and on sites such as Silk Road.

The organization Bitcoin.org, meanwhile, touts the currency's potential for opening up a "whole new platform for innovation":



Advantages and Disadvantages

A 2015 Congressional Research Service (CRS) report, "Bitcoin: Questions, Answers and Analysis of Legal Issues, explores the following technical, functional, and legal issues associated with Bitcoin—and, by extension, all virtual currencies.

Bitcoin advantages:

- Lower transaction costs: Because Bitcoin operates without a third-party intermediary, merchants are able to avoid the fees traditionally charged by payment systems such as credit cards.
- The possibility of increased privacy: Bitcoin provides a heightened degree of privacy for purchases and transactions, though by the system's nature, a complete list of all transactions is forever recorded to each user's encrypted identity.
- Protection from inflation: Since Bitcoin's circulation is not linked to currency or government regulation, it is not subject to standard inflation. However, it more than makes up for this in volatility.

Bitcoin disadvantages:

- Severe price volatility: The value of a Bitcoin is determined by supply and demand and, as a result, can fluctuate rapidly. The value was as high as $1,100 in December 2013, then hit a low of $177 in January 2015. This extreme fluctuation is more characteristic of a commodity than a currency.
- Not legal tender: Debtors are not required to accept it, and without any formal backing other than the computer program to which it is linked, Bitcoin can be seen as an "unattractive vehicle" for holding and accumulating wealth.
- Uncertain security against theft and fraud: While the counterfeiting of Bitcoins is allegedly impossible, the system has at times found itself vulnerable to large security breaches and cyberattacks. Most recently, Bitstamp, a large European Bitcoin exchange, lost 19,000 Bitcoins (valued at about $5 million) in a digital security breach. This follows the massive problems with Mt. Gox in 2014 and the collapse of other exchanges in 2011.
- Vulnerability of Bitcoin "wallets": Purchased or mined Bitcoins are stored in a digital wallet on the user's computer or mobile device, and digital keys can be lost, damaged, or stolen. Paper or offline storage is an option, but it's not always practiced.

Federal banking regulators have yet to issue guidance or regulations governing how banks are to deal with Bitcoins. In a February 2014 statement, Federal Reserve chair Janet Yellen said: "Bitcoin is a payment innovation that's taking place outside the banking industry. . . . There's no intersection at all, in any way, between Bitcoin and banks that the Federal Reserve has the ability to supervise and regulate." Some state financial authorities have taken steps to devise regulations, with New York's Department of Financial Services (NYDFS) in the lead.

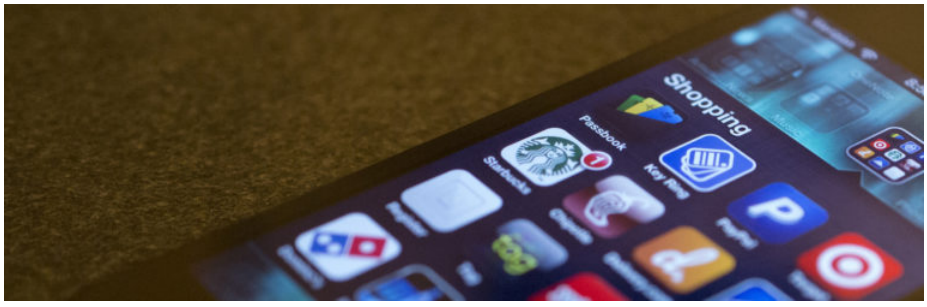
The responsibility to oversee digital currency falls upon Congress. As of now, Congressional actions remain in the exploratory phase. The tax code lacks clarity on how such currency should be treated: Is it digital currency, property, barter, or foreign currency? Early concerns have focused more on tackling consumer-protection issues than tax ambiguities, and as a result, the Consumer Financial Protection Bureau has become involved regarding questions related to Bitcoin.

The following video explains further some of the gray areas in which this virtual currency is operating.

Whether it's Bitcoin or another cryptocurrency, the fact that more than seven hundred of these unregulated digital currencies have emerged in just the last two years is just one more indication that consumers may be breaking off their longstanding love affair with traditional cash.

Mobile Commerce and Mobile Payment Systems

The term **mobile commerce** was first coined in 1997 by Kevin Duffey at the launch of the Global Mobile Commerce Forum to mean "the delivery of electronic commerce capabilities directly into the consumer's hand, anywhere, via wireless technology." Many think of mobile commerce as "a retail outlet in your customer's pocket."



Mobile commerce is worth US$230 billion annually, with Asia representing almost half of the market, and it's expected to reach US$700 billion in 2017. According to BI Intelligence, in January 2013, 29 percent of mobile users have now made a purchase with their phones. Walmart estimated that 40 percent of all visits to their Internet shopping site in December 2012 was from a mobile device. Bank of America projected that $67.1 billion in purchases would be made from mobile devices by European and U.S. shoppers in 2015.

Mobile Payment

Mobile payment, also referred to as mobile money, mobile money transfer, and mobile wallet, generally refers to payment services operated under financial regulation and performed from or via a mobile device. Instead of paying with cash, check, or credit cards, a consumer can use a mobile phone to pay for a wide range of services and digital or hard goods. Although the concept of using non-coin-based currency systems has a long history, only recently has the technology to support such systems become widely available.

Mobile payment is being adopted all over the world in different ways. In 2008, the combined market for all types of mobile payments was projected to reach more than $600 billion globally by 2013, which would be double the figure as of February, 2011. The mobile payment market for goods and services, excluding contactless Near Field Communication or NFC transactions and money transfers, exceeded $300 billion globally in 2013. Investment on mobile money services is expected to grow by 22.2 percent during the next two years across the globe. It will result in revenue share of mobile money reaching up to 9 percent by 2018. Asia and Africa will observe significant growth for mobile money, with technological innovation and focus on interoperability emerging as prominent trends by 2018.

In developing countries, mobile payment solutions have been deployed as a means of extending financial services to communities known as the "unbanked" or "underbanked," which are estimated to represent as much as 50 percent of the world's adult population, according to Financial Access's 2009 Report "Half the World is Unbanked."

Forms of Mobile Payment

Apple Pay is a mobile payment service that lets certain Apple mobile devices make payments at retail and online checkout. It digitizes and replaces the credit or debit magnetic stripe card transaction at credit card terminals. The service lets Apple devices wirelessly communicate with point of sale systems using a near field communication (NFC) antenna, a "dedicated chip that stores encrypted payment information" (known as the Secure Element), and Apple's Touch ID and Passbook.

The service keeps customer payment information private from the retailer, and creates a "dynamic security code [. . .] generated for each transaction." Apple added that they would not track usage, which would stay between the customers, the vendors, and the banks. Users can also remotely halt the service on a lost phone via the Find My iPhone service.

Google Wallet is a mobile payment system developed by Google that allows its users to store debit cards, credit cards, loyalty cards, and gift cards among other things, as well as redeeming sales promotions on their mobile phone. Google Wallet can use near field communication (NFC) to "make secure payments fast and convenient by simply tapping the phone on any PayPass-enabled terminal at checkout."

Where this new technology will lead the world economy and what its impact on the existing monetary system will be remain to be seen, but we are certain it will continue to evolve rapidly!

1. Chakravorti, B., & Mazzotta, B. (2013, September). The Cost of Cash in the United States. Retrieved September 8, 2016, from fletcher.tufts.edu/CostofCash...icrosites/Cost of Cash/CostofCashStudyFinal.pdf ↵

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4.3: Role of Banks

What you'll learn to do: explain the role of banks in the U.S. monetary system

In this section you'll learn how banks serve as intermediaries for the flow of money between lenders and borrowers. You'll also learn about the system in which which banks operate: the Federal Reserve System.

Learning Objectives

- Explain how banks act as intermediaries between savers and borrowers
- Explain how the Federal Reserve System implements monetary policy
- Explain how the Federal Reserve System implements monetary policy

Measuring and Tracking the Money Supply

Now that you have a good understanding of money, what qualifies as money, and how money facilitates exchanges between buyers and sellers, we need to look at how money evolves from a medium of exchange to a system. There was a time in the United States when there was no monetary system, and buyers and sellers who traveled from state to state had to carry multiple currencies. The Confederate States of America dollar was issued by the newly formed confederacy just before the outbreak of the American Civil War. It wasn't backed by hard assets (i.e., commodities) but simply by a promise to pay the bearer after the war, on the prospect of Southern victory and independence.[1] Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, South Carolina, Tennessee, Texas, and Virginia each printed and circulated currency that had value only within the state. It was not until 1863 when President Lincoln signed the National Banking Act that the federal dollar was established as the sole currency in the United States.

What about other kinds of currency? Cash in your wallet certainly serves as money, but how about checks or credit cards? Are they money, too? Rather than trying to determine a single way of measuring money, economists offer broader definitions of money based on liquidity. **Liquidity** refers to how quickly a financial asset can be used to buy a good or service. For example, cash is very liquid. Your $10 bill can easily be used to buy a hamburger at lunchtime. However, $10 that you have in your savings account is not so easy to use. You must go to the bank or ATM machine and withdraw that cash to buy your lunch. Thus, $10 in your savings account is *less* liquid.

The **Federal Reserve Bank,** which is the central bank of the United States, is a bank regulator. It's responsible for monetary policy, and it defines money according to its liquidity. You will learn more about the Federal Reserve System in the next section. There are two definitions of money: M1 and M2 money supply. **M1 money supply** includes those monies that are very liquid such as cash, checkable (demand) deposits, and traveler's checks. **M2 money supply** is less liquid in nature and includes M1 monies plus savings and time deposits, certificates of deposits, and money market funds.

M1 money supply includes **coins and currency in circulation**—the coins and bills that circulate in an economy that are not held by the U.S. Treasury, at the Federal Reserve Bank, or in bank vaults. Closely related to currency are checkable deposits, also known as **demand deposits**. These are the amounts held in checking accounts. They are called demand deposits or checkable deposits because the banking institution must give the deposit holder his money "on demand" when a check is written or a debit card is used. These items together—currency, and checking accounts in banks—comprise the money defined as M1, which is measured daily by the Federal Reserve System. Traveler's checks are also included in M1 but have recently decreased in use.

M2 is a broader category of money. It includes everything in M1 but also adds other types of deposits. For example, M2 includes **savings deposits** in banks, which are bank accounts on which you cannot write a check directly, but from which you can easily withdraw the money at an automatic teller machine or bank. Many banks and other financial institutions also offer a chance to invest in **money market funds**, where the deposits of many individual investors are pooled together and invested in a safe way, such as in short-term government bonds. Another portion of M2 are the relatively small (that is, less than about $100,000) **certificates of deposit** (CDs) or **time deposits**, which are accounts that the depositor has committed to leaving in the bank for a certain period of time, ranging from a few months to a few years, in exchange for a higher interest rate. In short, all these types of M2 are money that you can withdraw and spend, but which require a greater effort to do so than the items in M1. Figure 1, below, should help you visualize the relationship between M1 and M2. Note that M1 is included in the M2 calculation.

Figure 4.3.1. The Relationship between M1 and M2 Money.

The Federal Reserve System is responsible for tracking the amounts of M1 and M2 and prepares a weekly release of information about the money supply. For example, according to the Federal Reserve Bank's measure of the U.S. money stock, at the end of February 2015, M1 in the United States was $3 trillion, while M2 was $11.8 trillion. A breakdown of the portion of each type of money that comprised M1 and M2 in February 2015, as reported by the Federal Reserve Bank, is provided in Table 1.

Table 4.3.1. M1 and M2 Federal Reserve Statistical Release, Money Stock Measures

Components of M1 in the U.S. (February 2015, seasonally adjusted)	**$ billions**
Currency	$1,271.8
Traveler's checks	$2.9
Demand deposits and other checking accounts	$1,713.5
Total M1	*$2,988.2 (or $3 trillion)*
Components of M2 in the U.S. (February 2015, seasonally adjusted)	**$ billions**
M1 money supply	$2,988.2
Savings accounts	$7,712.1
Time deposits	$509.2
Individual money market mutual fund balances	$610.8
Total M2	*$11,820.3 (or $11.8 trillion)*

The lines separating M1 and M2 can become a little blurry. Sometimes elements of M1 are not treated alike; for example, some businesses will not accept personal checks for large amounts but will accept traveler's checks or cash. Changes in banking practices and technology have made the savings accounts in M2 more similar to the checking accounts in M1. For example, some savings accounts will allow depositors to write checks, use automatic teller machines, and pay bills over the Internet, which has made it easier to access savings accounts. As with many other economic terms and statistics, the important point is to know the strengths and limitations of the various definitions of money, not to believe that such definitions are as clear-cut to economists as, say, the definition of nitrogen is to chemists.

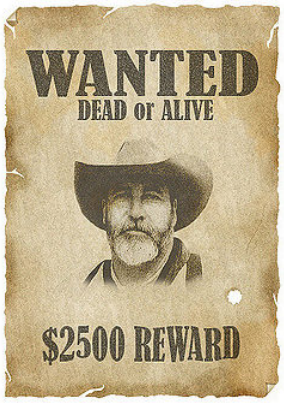
Where does "plastic money" like debit cards, credit cards, and smart money fit into this picture? A debit card, like a check, is an instruction to the user's bank to transfer money directly and immediately from your bank account to the seller. It is important to note that in our definition of money, it's checkable deposits that are money, not the paper check or the debit card. Although you can make a purchase with a credit card, it is not considered money but rather a short term loan from the credit card company to you. When you make a purchase with a credit card, the credit card company immediately transfers money from its checking account to the seller, and at the end of the month, the credit card company sends you a bill for what you have charged that month. Until you pay the credit card bill, you have effectively borrowed money from the credit card company. With a smart card, you can store a certain value of money on the card and then use the card to make purchases. Some "smart cards" used for specific purposes, like

long-distance phone calls or making purchases at a campus bookstore and cafeteria, are not really all that smart, because they can only be used for certain purchases or in certain places.

In short, credit cards, debit cards, and smart cards are different ways to move money when a purchase is made. But having more credit cards or debit cards does not change the quantity of money in the economy, any more than having more checks printed increases the amount of money in your checking account.

One key message here is that counting and tracking the money in a modern economy doesn't just involve paper bills and coins; instead, money is closely linked to bank accounts. Indeed, the macroeconomic policies concerning money are largely conducted through the banking system. The next section explains how banks function as an intermediary to financial transactions.

Banks As Financial Intermediaries



The late bank robber named Willie Sutton was once asked why he robbed banks. He answered: "That's where the money is." While this may have been true at one time, from the perspective of modern economists, Sutton is both right and wrong. He is wrong because the overwhelming majority of money in the economy is not in the form of currency sitting in vaults or drawers at banks, waiting for a robber to appear. Most money is in the form of bank accounts, which exist only as electronic records on computers. From a broader perspective, however, the bank robber was more right than he may have known. Banking is intimately interconnected with money and, consequently, with the broader economy.

Banks make it far easier for a complex economy to carry out the extraordinary range of transactions that occur in goods, labor, and financial capital markets. Imagine for a moment what the economy would be like if all payments had to be made in cash. When shopping for a large purchase or going on vacation, you might need to carry hundreds of dollars in a pocket or purse. Even small businesses would need stockpiles of cash to pay workers and to purchase supplies. A bank allows people and businesses to store this money in either a checking account or savings account, for example, and then withdraw this money as needed through the use of a direct withdrawal, writing a check, or using a debit card.

Banks are a critical intermediary in what is called the payment system, which helps an economy exchange goods and services for money or other financial assets. Also, people with extra money that they'd like to save can store their money in a bank rather than look for an individual who is willing to borrow it from them and then repay them at a later date. Those who want to borrow money can go directly to a bank rather than trying to find someone to lend them cash. Thus, banks act as financial intermediaries—they bring savers and borrowers together.

An **intermediary** is one who stands between two other parties. Banks are a **financial intermediary**—that is, an institution that operates between a saver who deposits money in a bank and a borrower who receives a loan from that bank. All the funds deposited are mingled in one big pool, which is then loaned out. Figure 2 illustrates the position of banks as financial intermediaries, with deposits flowing into a bank and loans flowing out.

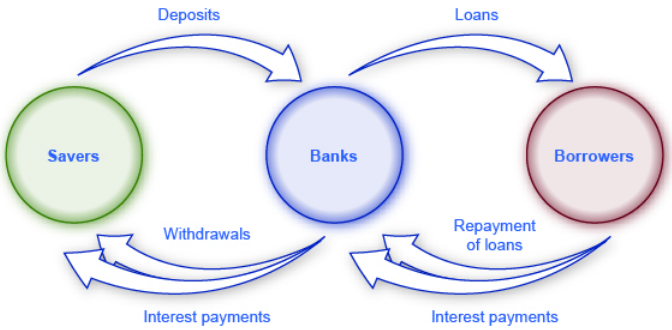


Figure 4.3.2. Banks As Financial Intermediaries.

For some concrete examples of what banks do, watch the following video from Paul Solman's *Making Sense of Financial News*.

The Federal Reserve System

Figure 4.3.3. **Marriner S. Eccles Federal Reserve Headquarters, Washington, DC.** Some of the most influential decisions regarding monetary policy in the United States are made behind these doors.

Money, loans, and banks are all tied together. Money is deposited in bank accounts, which is then loaned to businesses, individuals, and other banks. When the interlocking system of money, loans, and banks works well, economic transactions in goods and labor markets happen smoothly, and savers are connected with borrowers. If the money and banking system does not operate smoothly, the economy can either fall into recession or suffer prolonged inflation.

The government of every country has public policies that support the system of money, loans, and banking. But these policies do not always work perfectly. In this section we will explore how monetary policy works and what may prevent it from working perfectly.

In making decisions about the money supply—that is, the total amount of monetary assets available in an economy at a specific time—a central bank decides whether to raise or lower interest rates and, in this way, to influence macroeconomic policy, whose goal is low unemployment and low inflation. The central bank is also responsible for regulating all or part of the nation's banking system to protect bank depositors and insure the health of the bank's finances.

The organization responsible for conducting monetary policy and ensuring that a nation's financial system operates smoothly is called the **central bank**. Most nations have central banks or currency boards. Some prominent central banks around the world include the European Central Bank, the Bank of Japan, and the Bank of England. In the United States, the central bank is called the **Federal Reserve**—often abbreviated as "the Fed." This section explains the organization of the U.S. Federal Reserve and identifies the major responsibilities of a central bank.

Structure/Organization of the Federal Reserve

Unlike most central banks, the Federal Reserve is semi-decentralized, mixing government appointees with representation from private-sector banks. At the national level, it is run by a board of governors, consisting of seven members appointed by the president of the United States and confirmed by the Senate. Appointments are for fourteen-year terms and they are arranged so that one term expires January 31 of every even-numbered year. The purpose of the long and staggered terms is to insulate the board of

governors as much as possible from political pressure so that policy decisions can be made based only on their economic merits. In addition, except when filling an unfinished term, each member only serves one term, further insulating decision-making from politics. Policy decisions of the Fed do not require congressional approval, and the president cannot ask for the resignation of a Federal Reserve governor as the president can with cabinet positions.

One member of the board of governors is designated as the chair. For example, from 1987 until early 2006, the chair was Alan Greenspan. From 2006 until 2014, Ben Bernanke held the post. The current chair, Janet Yellen, has made many headlines already. Why? See the following feature to find out.

Who has the most immediate economic power in the world

Figure 4.3.4 .

Chair of the Federal Reserve Board.

Janet L. Yellen is the first woman to hold the position of chair of the Federal Reserve Board of Governors.

Figure 4, became the first woman to hold this post. Yellen has been described in the media as “perhaps the most qualified Fed chair in history.”

With a PhD in economics from Yale University, Yellen has taught macroeconomics at Harvard, the London School of Economics, and most recently at the University of California at Berkeley. From 2004–2010, Yellen was president of the Federal Reserve Bank of San Francisco.

Not an ivory-tower economist, Yellen became one of the few economists who warned about a possible bubble in the housing market, more than two years before the financial crisis occurred. Yellen served on the board of governors of the Federal Reserve twice, most recently as vice chair. She also spent two years as chair of the President’s Council of Economic Advisors. If experience and credentials mean anything, Yellen is likely to be an effective Fed chair.

The Fed chair is first among equals on the board of governors. While he or she has only one vote, the chair controls the agenda, and is the public voice of the Fed, so he or she has more power and influence than one might expect.

The Federal Reserve is more than the board of governors. The Fed also includes twelve regional **Federal Reserve banks**, each of which is responsible for supporting the commercial banks and economy generally in its district. The Federal Reserve districts and the cities where their regional headquarters are located are shown in Figure 4.3.5. The commercial banks in each district elect a board of directors for each regional Federal Reserve bank, and that board chooses a president for each regional Federal Reserve district. Thus, the Federal Reserve System includes both federally and private-sector appointed leaders.

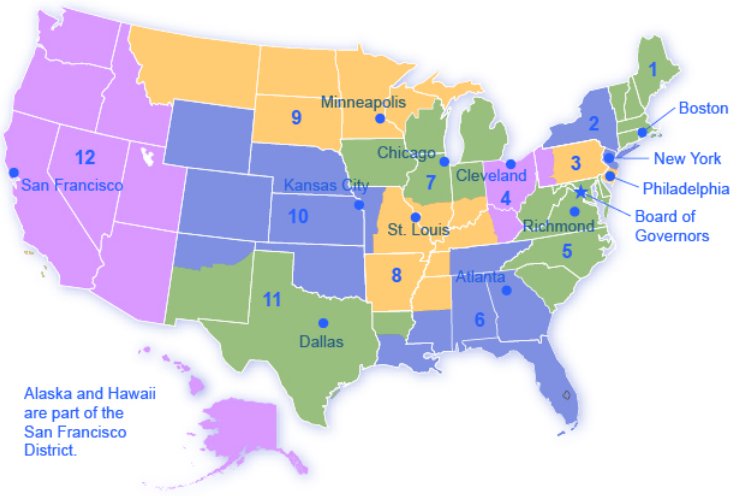


Figure 4.3.5. **The Twelve Federal Reserve Districts**. There are twelve regional Federal Reserve banks, each with its own district.

What Does a Central Bank Do?

The Federal Reserve, like most central banks, is designed to perform the following three important functions:

1. To conduct monetary policy
2. To promote stability of the financial system
3. To provide banking services to commercial banks and other depository institutions, and to provide banking services to the federal government

The Federal Reserve provides many of the same services to banks as banks provide to their customers. For example, all commercial banks have an account at the Fed where they deposit reserves, and they can obtain loans from the Fed through the "discount window," which will be discussed in the next reading. The Fed is also responsible for check processing. When you write a check to buy groceries, for example, the grocery store deposits the check in its bank account. Then, the physical check (or an image of that actual check) is returned to your bank, after which funds are transferred from your bank account to the account of the grocery store. The Fed is responsible for how these transactions are handled once the check leaves the cash register and is deposited into the store's bank account. Does that mean that your check to the grocery store goes all the way to Washington, DC.? No. Instead the regulations that govern how banks handle checks, deposits, withdrawals are regulated by The Federal Reserve Act. This act is the reason that a bank must start paying you interest on a savings deposit the day it is received. It's also the reason that if you deposit a large check, your bank may tell you that the funds will not be available for three to five business days.

On a more mundane level, the Federal Reserve ensures that enough currency and coins are circulating through the financial system to meet public demands. For example, each year the Fed increases the amount of currency available in banks around the Christmas shopping season and reduces it again in January.

Finally, the Fed is responsible for assuring that banks are in compliance with a wide variety of consumer protection laws. For example, banks are forbidden from discriminating on the basis of age, race, sex, or marital status. Banks are also required to publicly disclose information about the loans they make for buying houses and how those loans are distributed geographically, as well as by sex and race of the loan applicants.

How a Central Bank Executes Monetary Policy

The most important function of the Federal Reserve is to conduct the nation's monetary policy. Article I, Section 8 of the U.S. Constitution gives Congress the power "to coin money" and "to regulate the value thereof." As part of the 1913 legislation that created the Federal Reserve, Congress delegated these powers to the Fed. Monetary policy involves managing interest rates and credit conditions, which influence the level of economic activity, as described in more detail below.

A central bank has the following three traditional tools to implement monetary policy in the economy:

1. Open market operations
2. Changing reserve requirements
3. Changing the discount rate

In discussing how these three tools work, it is useful to think of the central bank as a "bank for banks"—that is, each private-sector bank has its own account at the central bank. We will discuss each of these monetary policy tools in the sections below.

Open Market Operations

The most commonly used tool of monetary policy in the U.S. is open market operations. **Open market operations** take place when the central bank sells or buys U.S. Treasury bonds in order to influence the quantity of bank reserves and the level of interest rates. The specific interest rate targeted in open market operations is the federal funds rate. The name is a bit of a misnomer since the federal funds rate is the interest rate charged by commercial banks making overnight loans to other banks. As such, it is a very short-term interest rate, but one that reflects credit conditions in financial markets very well.

The **Federal Open Market Committee (FOMC)** makes the decisions regarding these open market operations. The FOMC is made up of the seven members of the Federal Reserve's board of governors. It also includes five voting members who are drawn, on a rotating basis, from the regional Federal Reserve Banks. The New York district president is a permanent voting member of the FOMC and the other four spots are filled on a rotating, annual basis, from the other eleven districts. The FOMC typically meets every six weeks, but it can meet more frequently if necessary. The FOMC tries to act by consensus; however, the chairman of the Federal Reserve has traditionally played a very powerful role in defining and shaping that consensus. For the Federal Reserve, and for most central banks, open market operations have, over the last few decades, been the most commonly used tool of monetary policy. The following video explains how these operations work.

s by the central bank that increases bank reserves and lowers interest rates, **or** is it a purchase of bonds by the easy way to keep track of this is to treat the central bank as being *outside* the banking system. When a central bank buys bonds, money is flowing from the central bank to individual banks in the economy, increasing the supply of money in circulation. When a central bank sells bonds, then money from individual banks in the economy is flowing into the central bank—reducing the quantity of money in the economy.

Changing Reserve Requirements

A second method of conducting monetary policy is for the central bank to raise or lower the **reserve requirement,** which is the percentage of each bank's deposits that it is legally required to hold either as cash in their vault or on deposit with the central bank. If banks are required to hold a greater amount in reserves, they have less money available to lend out. If banks are allowed to hold a smaller amount in reserves, they will have a greater amount of money available to lend out. The following video will explain how changing the reserve requirement alters the money supply.

Federal Reserve required banks to hold reserves equal to 0% of the first $14.5 million in deposits, then to hold % of the deposits up to $103.6 million, and 10% of any amount above $103.6 million. Small changes in the reserve requirements are made almost every year. For example, the $103.6 million dividing line is sometimes bumped up or down by a few million dollars. In practice, large changes in reserve requirements are rarely used to execute monetary policy. A sudden demand that all banks increase their reserves would be extremely disruptive and difficult to comply with, while loosening requirements too much would create a danger of banks being unable to meet the demand for withdrawals.

Changing the Discount Rate

The Federal Reserve was founded in the aftermath of the Financial Panic of 1907 when many banks failed as a result of bank runs. As mentioned earlier, since banks make profits by lending out their deposits, no bank, can withstand a bank run. As a result of the Panic, the Federal Reserve was founded to be the "lender of last resort." In the event of a bank run, sound banks could borrow as much cash as they needed from the Fed's discount "window" to cover the bank run. The interest rate banks pay for such loans is called the **discount rate**. They are so named because loans are made against the bank's outstanding loans "at a discount" of their face value. Once depositors became convinced that the bank would be able to honor their withdrawals, they no longer had a reason to make a run on the bank. In short, the Federal Reserve was originally intended to provide credit passively, but in the years since its founding, the Fed has taken on a more active role with monetary policy.

So, the third traditional method for conducting monetary policy is to raise or lower the discount rate. If the central bank raises the discount rate, then commercial banks will reduce their borrowing of reserves from the Fed, and instead call in loans to replace those reserves. Since fewer loans are available, the money supply falls and market interest rates rise. If the central bank lowers the discount rate it charges to banks, the process works in reverse.
The following video explains the impact of changes to the Fed's discount rate.

In recent decades, the Federal Reserve has made relatively few discount loans. Before a bank borrows from the Federal Reserve to fill out its required reserves, the bank is expected to first borrow from other available sources, like other banks. This is encouraged by the Fed charging a higher discount rate than the federal funds rate. Given that most banks borrow little at the discount rate,

changing the discount rate up or down has little impact on their behavior. More important, the Fed has found from experience that open market operations are a more precise and powerful means of executing any desired monetary policy.

Chair the Fed

Achieve Low Unemployment *and* Low Inflation Rates

We have now seen that the Fed has three primary goals and a set of tools at its disposal to help it achieve these goals. If *you* were the chairperson of the Federal Reserve, do you think that you could accomplish these goals? Let's find out!

After reading the following information, click on the Chair the Fed link below, which will take you to the Federal Reserve Bank of San Francisco Web site, where YOU will act as the Chair of the Fed. By manipulating the fed funds rate, you will try to keep inflation and unemployment at target rates.

Instructions for Playing the Game

The game puts the player in the role of setting monetary policy as Chair of the Fed. The goals are as follows: inflation (2 percent) and unemployment (5 percent). Remember that the fed funds rate is the primary tool for monetary policy and is shown on the game screen (green line in the chart area is initially set at 4 percent rate).

Record the starting levels for inflation, unemployment, and the fed funds rate (2.11 percent, 4.68 percent, and 4.00 percent, respectively) in your notes by making a small table with four columns labeled: Quarters Remaining, Inflation, Unemployment, and Fed Funds Rate.

Review the "rules" and functions of the simulation by clicking on "**YOUR JOB**." Once you have familiarized yourself with the way the simulation works, you are ready to "GO."

Start the game by clicking on the "**Go**" button. Once the first quarter is completed (fifteen quarters remaining), record all three rates. Using the "raise" and "cut" buttons, make adjustments to the fed funds rate. The information in the headline reflects changes in the levels of inflation and unemployment.

Work through the remaining fifteen quarters, pausing to review each headline and record the new values of inflation and unemployment.

The game ends on an announcement screen indicating "Congratulations" if the Chair has kept the economy on track (close to the goals for inflation and unemployment) or "Sorry" if the goals have not been met.

Good Luck!

Play the Chair the Fed Simulation

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1. https://en.Wikipedia.org/wiki/Confederate_States_dollar ↵

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4.4: Financial Markets and Business

What you'll learn to do: describe common ways in which businesses obtain financial capital (money) to fund operations

In this section you will learn about some of the options businesses have to obtain capital and how they decide which form of capital best meets their needs.

Learning Objectives

- Distinguish between bonds and bank loans as methods of borrowing
- Define "stock"

How Businesses Raise Financial Capital

Firms often make decisions that involve spending money in the present and expecting to earn profits in the future. Some examples are: when a firm buys a machine that will last ten years, or builds a new plant that will last for thirty years, or starts a research and development project. They need economic resources—also known as **financial capital**—to do this. Firms can raise the financial capital they need to pay for such projects in four main ways: (1) from early-stage investors; (2) by reinvesting profits; (3) by borrowing through banks or bonds; and (4) by selling stock. As you'll see, each financial option has different implications for the business in terms of operations and profits.

Early-Stage Financial Capital

Firms that are just beginning often have an idea or a prototype for a product or service to sell, but they have few customers, or even no customers at all, and thus are not earning profits. Banks are often unwilling to loan money to start-up businesses because they're seen as too risky. Such firms face a difficult problem when it comes to raising financial capital: How can a firm that has not yet demonstrated any ability to earn profits pay a rate of return to financial investors?

For many small businesses, the original source of money is the owner of the business. Someone who decides to start a restaurant or a gas station, for instance, might cover the start-up costs by dipping into his or her own bank account or by borrowing money (perhaps using a home as collateral). Alternatively, many cities have a network of well-to-do individuals, known as "angel investors," who will put their own money into small new companies at an early stage of development, in exchange for owning some portion of the firm.

Venture capital firms make financial investments in new companies that are still relatively small in size but have substantial growth potential. These firms gather money from a variety of individual or institutional investors, including banks, institutions like college endowments, insurance companies that hold financial reserves, and corporate pension funds. Venture capital firms do more than just supply money to small start-ups. They also provide advice on potential products, customers, and key employees. Typically, a venture capital fund invests in a number of firms, and then investors in that fund receive returns according to how the fund performs as a whole.

The amount of money invested in venture capital fluctuates substantially from year to year: As one example, venture capital firms invested more than $48.3 billion in 2014, according to the National Venture Capital Association. All early-stage investors realize that the majority of small start-up businesses will never hit it big; indeed, many of them will go out of business within a few months or years. They also know that getting in on the ground floor of a few huge successes like a Netflix or an Amazon.com can make up for a lot of failures. Early-stage investors are therefore willing to take large risks in order to be in a position to gain substantial returns on their investment.

Profits As a Source of Financial Capital

If firms are earning profits (their revenues are greater than costs), they can choose to reinvest some of these profits in equipment, structures, and research and development. For many established companies, reinvesting their own profits is one primary source of financial capital. Companies and firms just getting started may have numerous attractive investment opportunities but few current profits to invest. Even large firms can experience a year or two of earning low profits or even suffering losses, but unless the firm can find a steady and reliable source of financial capital so that it can continue making real investments in tough times, the firm may not survive until better times arrive. Firms often need to find sources of financial capital other than profits.

Borrowing: Banks and Bonds

When a firm has a record of at least earning significant revenues or, better still, of earning profits, the firm can make a credible promise to pay interest, and so it becomes possible for the firm to borrow money. Firms have two main methods of borrowing: banks and bonds.

A bank loan for a firm works in much the same way as a loan for an individual who is buying a car or a house. The firm borrows an amount of money and then promises to repay it, including some rate of interest, over a predetermined period of time. If the firm fails to make its loan payments, the bank (or banks) can often take the firm to court and require it to sell its buildings or equipment to make the loan payments.

Another source of financial capital is a bond. A **bond** is a financial contract: A borrower agrees to repay the amount that was borrowed and also a rate of interest over a period of time in the future. A **corporate bond** is issued by firms, but bonds are also issued by various levels of government. For example, a municipal bond is issued by cities, a state bond by U.S. states, and a Treasury bond (T-bond) by the federal government through the U.S. Department of the Treasury. A bond specifies an amount that will be borrowed, the interest rate that will be paid, and the time until repayment.

A large company, for example, might issue bonds for $10 million; the firm promises to make interest payments at an annual rate of 8 percent ($800,000 per year), and then, after ten years, it will repay the $10 million it originally borrowed. When a firm issues bonds, the total amount that is borrowed is divided up. A firm that seeks to borrow $50 million by issuing bonds might actually issue 10,000 bonds of $5,000 each. In this way, an individual investor could, in effect, loan the firm $5,000, or any multiple of that amount. Anyone who owns a bond and receives the interest payments is called a **bondholder**. If a firm issues bonds and fails to make the promised interest payments, the bondholders can take the firm to court and require it to pay, even if the firm needs to raise the money by selling buildings or equipment. However, there is no guarantee that the firm will have sufficient assets to pay off the bonds. The bondholders may get back only a portion of what they loaned the firm.

Bank borrowing is more customized than issuing bonds, so it often works better for relatively small firms. The bank can get to know the firm extremely well—often because the bank can monitor sales and expenses quite accurately by looking at deposits and withdrawals. Relatively large and well-known firms often issue bonds instead. They use bonds to raise new financial capital that pays for investments, or to raise capital to pay off old bonds, or to buy other firms. However, the idea that banks are usually used for relatively smaller loans and bonds for larger loans is not an ironclad rule: Sometimes groups of banks make large loans, and sometimes relatively small and lesser-known firms issue bonds.

Corporate Stock and Public Companies

A corporation is a business that "incorporates"—it is owned by shareholders that have limited liability for the debt of the company but share in its profits (and losses). Corporations may be private or public and may or may not have stock that is publicly traded. They may raise funds to finance their operations or new investments by raising capital through the sale of stock or the issuance of bonds.

Those who buy the stock become the owners, or shareholders, of the firm. **Stock** represents ownership of a firm; that is, a person who owns 100 percent of a company's stock, by definition, owns the entire company. The stock of a company is divided into shares. Corporate giants like IBM, AT&T, Ford, General Electric, Microsoft, Merck, and Exxon all have millions of shares of stock. In most large and well-known firms, no individual owns a majority of the shares of the stock. Instead, large numbers of shareholders—even those who hold thousands of shares—each have only a small slice of the overall ownership of the firm.

When a company is owned by a large number of shareholders, three important questions emerge:

1. How and when does the company get money from the sale of its stock?
2. What rate of return does the company promise to pay when it sells stock?
3. Who makes decisions in a company owned by a large number of shareholders?

First, a firm receives money from the sale of its stock only when the company sells its own stock to the public (the public includes individuals, mutual funds, insurance companies, and pension funds). A firm's first sale of stock to the public is called an initial public offering (**IPO**). The IPO is important for two reasons. For one, the IPO, and any stock issued thereafter, such as stock held as treasury stock (shares that a company keeps in their own treasury) or new stock issued later as a secondary offering, provides the funds to repay the early-stage investors, like the angel investors and the venture capital firms. A venture capital firm may have a 40 percent ownership in the firm. When the firm sells stock, the venture capital firm sells its part ownership of the firm to the public.

A second reason for the importance of the IPO is that it provides the established company with financial capital for a substantial expansion of its operations.

Most of the time when corporate stock is bought and sold, however, the firm receives no financial return at all. If you buy shares of stock in General Motors, you almost certainly buy them from the current owner of those shares, and General Motors does not receive any of your money. This pattern should not seem particularly odd. After all, if you buy a house, the current owner gets your money, not the original builder of the house. Similarly, when you buy shares of stock, you are buying a small slice of ownership of the firm from the existing owner—and the firm that originally issued the stock is not a part of this transaction.

Second, when a firm decides to issue stock, it must recognize that investors will expect to receive a rate of return. That rate of return can come in two forms. A firm can make a direct payment to its shareholders, called a **dividend**. Alternatively, a financial investor might buy a share of stock in Walmart for $45 and then later sell that share of stock to someone else for $60, for a gain of $15. The increase in the value of the stock (or of any asset) between when it is bought and when it is sold is called a **capital gain**.

Third: Who makes the decisions about when a firm will issue stock, or pay dividends, or reinvest profits? To understand the answers to these questions, it is useful to separate firms into two groups: private and public.

A **private company** is owned by the people who run it on a day-to-day basis. A private company can be run by individuals, in which case it is called a **sole proprietorship**, or it can be run by a group, in which case it is a **partnership**. A private company can also be a corporation, but the stock is not sold to the public. Instead, the company's stock is offered, owned, and traded or exchanged privately. A small law firm run by one person, even if it employs some other lawyers, would be a sole proprietorship. A larger law firm may be owned jointly by its partners. Most private companies are relatively small, but there are some large private corporations, with tens of billions of dollars in annual sales, that do not have publicly issued stock, such as farm-products dealer Cargill, the Mars candy company, and the Bechtel engineering and construction firm.

When a firm decides to sell stock, which in turn can be bought and sold by financial investors, it is called a **public company**. Shareholders own a public company. Since the shareholders are a very broad group, often consisting of thousands or even millions of investors, the shareholders vote for a board of directors, who in turn hire top executives to run the firm on a day-to-day basis. The more shares of stock a shareholder owns, the more votes that shareholder is entitled to cast for the company's board of directors.

In theory, the board of directors helps to ensure that the firm is run in the interests of the true owners—the shareholders. However, the top executives who run the firm have a strong voice in choosing the candidates who will be on their board of directors. After all, few shareholders are knowledgeable enough or have enough of a personal incentive to spend energy and money nominating alternative members of the board.

How Firms Choose between Sources of Financial Capital

There are clear patterns in how businesses raise financial capital. These patterns can be explained partly by the fact that buyers and sellers in a market do not both have complete and identical information. Those who are actually running a firm will almost always have more information about whether the firm is likely to earn profits in the future than outside investors who provide financial capital.

Any young start-up firm is a risk; indeed, some start-up firms are only a little more than an idea on paper. The firm's founders inevitably have better information about how hard they are willing to work, and whether the firm is likely to succeed, than anyone else. When the founders put their own money into the firm, they demonstrate a belief in its prospects. At this early stage, angel investors and venture capitalists try to get all the information they need, partly by getting to know the managers and their business plan personally and by giving them advice.

As a firm becomes at least somewhat established and its strategy appears likely to lead to profits in the near future, knowing the individual managers and their business plans on a personal basis becomes less important, because information has become more widely available regarding the company's products, revenues, costs, and profits. As a result, other outside investors who do not know the managers personally, like bondholders and shareholders, are more willing to provide financial capital to the firm.

At this point, a firm must often choose how to access financial capital. It may choose to borrow from a bank, issue bonds, or issue stock. The great disadvantage of borrowing money from a bank or issuing bonds is that the firm commits to scheduled interest payments, whether or not it has sufficient income. The great advantage of borrowing money is that the firm maintains control of its operations and is not subject to shareholders. Issuing stock involves selling off ownership of the company to the public and becoming responsible to a board of directors and the shareholders.

The benefit of issuing stock is that a small and growing firm increases its visibility in the financial markets and can access large amounts of financial capital for expansion, without worrying about paying this money back. If the firm is successful and profitable, the board of directors will need to decide upon a dividend payout or how to reinvest profits to further grow the company. Issuing and placing stock is expensive, requires the expertise of investment bankers and attorneys, and entails compliance with reporting requirements to shareholders and government agencies, such as the federal Securities and Exchange Commission.

Financial Markets

In 2006, housing equity in the United States peaked at $13 trillion. That means that the market prices of homes, less what was still owed on the loans used to buy these houses, equaled $13 trillion. This was a very good number, since the equity represented the value of the financial asset most U.S. citizens owned.

However, by 2008 this number had gone down to $8.8 trillion, and it declined further still in 2009. Combined with the decline in value of other financial assets held by U.S. citizens, by 2010, U.S. homeowners' wealth had declined by $14 trillion! This is a staggering loss, and it affected millions of lives: people had to alter their retirement decisions, housing decisions, and other important consumption decisions. Just about every other large economy in the world suffered a decline in the market value of financial assets, as a result of the global financial crisis of 2008–2009.

This section will explain why people buy houses (other than as a place to live), why they buy other types of financial assets, and why businesses sell those financial assets in the first place. The section will also give us insight into why financial markets and assets go through boom-and-bust cycles like the one described here.

When a firm needs to buy new equipment or build a new facility, it often must go to the financial market to raise funds. Usually firms will add capacity during an economic expansion when profits are on the rise and consumer demand is high. Business investment is one of the critical ingredients needed to sustain economic growth. Even in the sluggish economy of 2009, U.S. firms invested $1.4 trillion in new equipment and structures, in the hope that those investments would generate profits in the years ahead.

Between the end of the recession in 2009 through the second quarter 2013, profits for the S&P 500 companies grew to 9.7 percent despite the weak economy, with much of that amount driven by cost cutting and reductions in input costs, according to the *Wall Street Journal*. Figure 4.4.1, below, shows corporate profits after taxes (adjusted for inventory and capital consumption). Despite the steep decline in quarterly net profit in 2008, profits have recovered and surpassed pre-Recession levels.

Figure 4.4.1. **Corporate Profits after Tax (Adjusted for Inventory and Capital Consumption)**. Until 2008, corporate profits after tax have generally continued to increase each year. There was a significant drop in profits during 2008 and into 2009. The profit trend has since continued to increase each year, though at a less steady or consistent rate. (Source: Federal Reserve Economic Data (FRED) https://research.stlouisfed.org/fred2/series/CPATAX)

Many firms, from huge companies like General Motors to start-up firms writing computer software, do not have the financial resources within the firm to make all the investments they want. These firms need financial capital from outside investors, and they are willing to pay interest for the opportunity to get a rate of return on the investment for that financial capital.

On the other side of the financial capital market, suppliers of financial capital, like households, wish to use their savings in a way that will provide a return. Individuals cannot, however, take the few thousand dollars that they save in any given year, write a letter

to General Motors or some other firm, and negotiate to invest their money with that firm. Financial capital markets bridge this gap: That is, they find ways to take the inflow of funds from many separate suppliers of financial capital and transform it into the funds desired by demanders of financial capital. Such financial markets include stocks, bonds, bank loans, and other financial investments.

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4.5: Putting It Together- Financial Markets and System

Synthesis

Still have that dollar bill handy that you pulled out earlier when you learned about the Federal Reserve System? Do you think about it the same way you did before you completed this module? Perhaps you do, but now you should have a better understanding of what that dollar bill represents, how it came into existence, and where its value comes from. Money will always exist in some form, whether it's based on NFC technology in your iPhone or we go back to a barter system where we trade seashells for bread. It will still motivate people to work, study, achieve, and unfortunately even break the law. But, as you consider everything you have read and heard in this module, is it the money itself that is the motivator or the "store of value" that we work to obtain? In fact, you can look at that dollar bill and, really, it's just a piece of paper with a picture of a dead president on its face—it has no intrinsic value. So where is the value in the dollar bill you're holding? Is it that our society recognizes it as having value, and business and individuals are willing to "trade" you dollars for shoes, cars, houses, food, and the other things that you need or want in your day-to-day life? Yes, we could go back to trading chickens for shoes, but technology is pushing us further and further away from that model, and as the monetary system evolves, it's unlikely that it will become less complex. That's one big reason you've spent all this time understanding this thing that "makes the world go 'round."

Summary

This module covered the financial markets and system. Below is a summary of the topics covered in this module.

Money

Money serves three basic functions:

- **Medium of exchange**: because you can use it to buy the goods and services you want, everyone's willing to trade things for money.
- **Measure of value**: it simplifies the exchange process because it's a means of indicating how much something costs.
- **Store of value**: people are willing to hold on to it because they're confident that it will keep its value over time.
- Virtual currencies, such as BitCoin, are using the traditional concept of "money" but as an alternative to the established Federal Reserve System. Although gaining in popularity, these virtual currencies are unregulated and pose some serious risks to those using this medium of exchange.
- Cashless payment systems such as Google Wallet and ApplePay allow consumers to carry their "cash" in their mobile devices. As more retailers move to "tap to pay" or scanning QR codes to complete transactions, the need to carry conventional paper money and coin diminishes. The question raised by this technology is not whether it will lead to a cashless society, but rather which mobile payment service will rise to the top and capture the market.

Role of Banks

- The government uses two measures to track the money supply: **M-1** includes the most liquid forms of money, such as cash and checking-account funds. **M-2** includes everything in M-1 plus near-cash items, such as savings accounts and time deposits below $100,000.
- Financial institutions serve as financial intermediaries between savers and borrowers and direct the flow of funds between the two groups.
- Financial institutions offer a wide range of services, including checking and savings accounts, ATM services, and credit and debit cards. They also sell securities and provide financial advice.
- A bank holds on to only a fraction of the money that it takes in—an amount called its **reserves**—and lends out the rest to individuals, businesses, and governments. In turn, borrowers put some of these funds back into the banking system, where they become available to other borrowers. The **money multiplier** effect ensures that the cycle expands the money supply.
- Most large banks are members of the central banking system called the **Federal Reserve System** (commonly known as "the Fed").
- The Fed's goals include price stability, sustainable economic growth, and full employment. It uses *monetary policy* to regulate the money supply and the level of interest rates.

- To achieve these goals, the Fed has three tools:
  - it can raise or lower **reserve requirements**—the percentage of its funds that banks must set aside and can't lend out;
  - it can raise or lower the **discount rate**—the rate of interest that the Fed charges member banks to borrow "reserve" funds;
  - it can conduct **open market operations**—buying or selling government securities on the open market.

Financial Markets and Business

The four main ways that businesses raise financial capital are:

- **Early-stage capital**: business owner uses his/her own money or seeks money from an angel investor or venture capital firm
- **Profits:** profits from the business are reinvested in equipment, structures, research and development, etc.
- **Bonds:** a way to raise capital through borrowing, used by corporations and governments; an investment for the bondholder that creates return through regular, fixed, or floating interest payments on the debt and the repayment of principal at maturity; traded on bond exchanges through brokers.
- **Stocks:** a way to raise capital by selling ownership or equity; an investment for shareholders that creates return through the distribution of corporate profits as dividends or through gains (losses) in corporate value; traded on stock exchanges through member brokers.

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CHAPTER OVERVIEW

5: Legal Environment

5.1: Why It Matters- Legal Environment
5.2: The Meaning and Purpose of Law
5.3: Statutory and Common Law
5.4: Tort Law
5.5: Intellectual Property
5.6: Warranties
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5.9: Consumer Protection and Antitrust Laws

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5.1: Why It Matters- Legal Environment

Why summarize the role of the legal system in governing and shaping the climate for business?

Imagine yourself in the following story: When you were in high school, you sometimes worked for your father, a house painter. Now that you're in college, you've decided to take advantage of that experience to earn some extra money during your summer vacation. You've set yourself up as a house-painting business and hired your college roommate to help you out.

One fine summer day, the two of you were putting a coat of Misty Meadow acrylic latex on the exterior of a two-story Colonial. You were working on the ground floor around the door of the house while your roommate was working from scaffolding over the garage. Looking up, you noticed that—despite several warnings—your roommate had placed his can of paint at his feet rather than having fixed it to the ladder bracing the platform. You were about to say something yet again, but it was too late: He accidentally kicked the bucket (so to speak), which then bounced off the homeowner's red sports car, denting the hood, and splattering it with Misty Meadow.

As luck would have it, the whole episode was witnessed by the homeowner's neighbor, who approached the scene of the disaster just as your roommate climbed down from the scaffold. "Man, you must be dumber than a bag of hammers," the neighbor said to your roommate, who was in no mood for unsolicited opinions—and before you knew what was happening, he broke the neighbor's nose with a single well-placed punch.

The homeowner sues you and your roommate for negligence, and the neighbor sues you and your roommate for assault and battery.

In this module, we will discuss how our legal system shapes the business environment. We will explore how legal situations like this and others could impact your business.

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5.2: The Meaning and Purpose of Law

What you'll learn to do: explain the meaning and purpose of law

In this section you'll be introduced to the terms and concepts needed to understand how law applies to business.

Learning Objectives

- Explain the purposes of law
- Explain "rule of law"

Understanding Law

Law has been defined as "a body of rules of action or conduct prescribed by a controlling authority, and having binding legal force. That which must be obeyed and followed by citizens subject to sanctions or legal consequence is a law."[1]

Although intended to protect the fundamental rights and liberties of U.S. citizens, the legal system and its laws are not always readily understood by the average citizen. At what point do we cross that fine line between legal and illegal, and on what basis is that line even drawn in the first place? Most people understand (and accept) laws prohibiting acts of murder, thievery, physical harm, and financial malfeasance, but there are plenty of other laws that might give us pause. For example, in Minnesota, any game in which participants attempt to capture a greased or oiled pig is illegal. The same laws also prohibits turkey scrambles.[2] Don't attempt to substitute a ferret for a hunting dog in West Virginia. Anyone who hunts, catches, takes, kills, injures, or pursues a wild animal or bird with a ferret will face a fine of no less than $100 (but no more than $500) and no fewer than 10 (but no more than 100) days in jail.[3]

While you may never have considered taking part in a turkey scramble or hunting with a ferret, chances are good that you have broken some law at some time—perhaps even in the last twenty-four hours. Did you exceed a speed limit while driving? Roll through a stop sign at an empty intersection while riding your bike? Drive to the minimart without wearing your seatbelt? Although unlikely that you will be prosecuted and jailed for these minor traffic offenses, the fact is that you broke the law. Why do we have so many laws? Let's take a closer look at the role of law in society and why laws are created in the first place.

Purposes of Law

In a society such as the United States, the law informs everyday life in a wide variety of ways and is reflected in numerous branches of law. For example, contract law regulates agreements to exchange goods, services, or anything else of value, so it includes everything from buying a bus ticket to trading options on a derivatives market. Property law defines people's rights and duties toward tangible property, including real estate (i.e., *real property*, such as land or buildings,) and their other possessions (i.e., *personal property*, such as clothes, books, vehicles, and so forth), and intangible property, such as bank accounts and shares of stock. Tort law provides for compensation when someone or their property is harmed, whether in an automobile accident or by defamation of character. Those are fields of civil law, which deals with disputes between individuals. Offenses against a federal, state, or local community itself are the subject of criminal law, which provides for the government to punish the offender.

origins of law

The establishment of a system of laws was not invented by the founding fathers of the United States. The idea of written laws goes back to ancient Mesopotamian culture that prospered long before the Bible was written or the civilizations of the Greeks or Romans flowered.

In fact, the oldest known evidence of a law code is tablets from the ancient city Ebla (Tell Mardikh in modern-day Syria). They date to about 2400 BCE. However, most scholars credit Hammurabi's Code as the origin of written laws and a formal legal system. If you haven't heard of Hammurabi, you have certainly heard one of his laws: "An eye for an eye, and a tooth for a tooth." Hammurabi's Code, a

> collection of 282 laws inscribed on an upright stone pillar, contains many fundamental legal concepts we would recognize in today's legal system.
>
> In fact, Hammurabi's reasoning for creating this code is not that far removed from the rationale for our current legal system. In his preface, Hammurabi writes that he sets forth these laws "to bring about the rule of righteousness in the land, to destroy the wicked and the evil-doers; so that the strong should not harm the weak."

Establishing Standards

The law is a guidepost for minimally acceptable behavior in society. Some activities, for instance, are crimes because society (through a legislative body) has determined that it will not tolerate certain behaviors that injure or damage persons or their property. For example, under a typical state law, it is a crime to cause physical injury to another person without justification—doing so generally constitutes the crime of assault.[4]

Maintaining Order

This is an offshoot of establishing standards. Some semblance of order is necessary in a civil society and is therefore reflected in law. The law—when enforced—provides order consistent with society's guidelines. Wildlife management laws, for example, (such as West Virginia's prohibition against using ferrets for hunting,) were first passed in an effort to conserve game that had nearly been hunted into extinction during the nineteenth century. Such laws reflect the value society places on protecting wildlife for future generations to enjoy.[5]

Resolving Disputes

Disputes are unavoidable in a society comprised of persons with different needs, wants, values, and views. The law provides a formal means for resolving disputes—the court system.[6]

Protecting Liberties and Rights

The constitutions and statutes of the United States and its states provide for various liberties and rights. One function of the law is to protect these various liberties and rights from violations or unreasonable intrusions by persons, organizations, or government. For example, subject to certain exceptions, the First Amendment to the Constitution prohibits the government from making a law that prohibits the freedom of speech. Someone who believes that his free speech rights have been prohibited by the government may pursue a remedy by bringing a case in the courts.[7]

Rule of Law

What is the rule of law? Aren't laws and rules the same thing? You can think of the rule of law as the *rules that govern the law*. The **rule of law** is the legal principle that law should govern a nation, as opposed to being governed by arbitrary decisions of individual government officials. It primarily refers to the influence and authority of law within society, particularly as a constraint upon behavior, including behavior of government officials. The phrase can be traced back to sixteenth-century Britain, and in the following century, the Scottish theologian Samuel Rutherford used the phrase in his argument against the divine right of kings. The concept, if not the phrase, was familiar to ancient philosophers such as Aristotle, who wrote, "Law should govern."

Rule of law implies that every citizen is subject to the law, including lawmakers themselves. In this sense, the rule of law stands in contrast to an autocracy, dictatorship, or oligarchy, in which the rulers are held above the law. Lack of the rule of law can be found in both democracies and dictatorships, because of neglect or ignorance of the law, for example, and the rule of law is more apt to deteriorate if a government has insufficient corrective mechanisms for restoring it. If you've ever read *Alice's Adventures in Wonderland* (or seen the movie), and you can recall the Queen of Hearts yelling, "Off with their heads!" at the slightest infraction or offense, you have some idea of what it would be like to live in a society that is not governed by the rule of law.

The rule of law system in the United States is established in the U.S. Constitution. The U.S. Constitution itself became the law of the land well over two hundred years ago, and the tenets set forth in the document remain in full force today. The way in which the Constitution is applied, though, has always been subject to court interpretation. As circumstances and public opinion evolve through the years, so too do the interpretations offered by the courts. From time to time, it even becomes necessary to amend the Constitution to keep pace with changes in the country's beliefs and values.

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1. Black's Law Dictionary, 6th ed., s.v. "law." ↵
2. www.revisor.mn.gov/statutes/?id=343.36&year=2013&keyword_type=all&keyword=greased+pig ↵
3. http://www.legis.state.wv.us/legisdocs/code/20/WVC%2020%20%20-%20%202%20%20-%20%20%205%20%20.htm ↵
4. http://www.businesslawbasics.com/chapter-3-purposes-and-functions-law-1 ↵
5. http://www.businesslawbasics.com/chapter-3-purposes-and-functions-law-1 ↵
6. http://www.businesslawbasics.com/chapter-3-purposes-and-functions-law-1 ↵
7. http://www.businesslawbasics.com/chapter-3-purposes-and-functions-law-1 ↵

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5.3: Statutory and Common Law

What you'll learn to do: differentiate between statutory and common law

In this section you'll learn about the differences between statutory and common law.

Learning Objectives

- Define common law

Statutory vs. Common Law

At both the federal and state levels, the law of the United States can be traced back to the common law system of English law, which was in force in the American colonies during the time of the Revolutionary War. Since then, U.S. law has diverged greatly from its English roots both in terms of substance and procedure. The main departure occurred when the United States ratified the Constitution in 1789. In effect, the Constitution and federal statutes and laws made in furtherance of the Constitution were established as "the supreme Law of the Land." From that point on, the law of the land was no longer based on legal practices in England but became distinctly American and home grown. When the individual states ratified their state constitutions, the state legislatures obtained the power to establish state law, or the "Law of the State." Together, this collection of federal and state laws constitutes something we often refer to as the "body of law." This body of law governs the behavior of individuals, businesses, and even governments. Just like the human body, the "body of law" is comprised of multiple parts, each performing an individual function while simultaneously working together as a whole. In this section, we will examine two of the most fundamental types of laws, followed by nearly every nation in the world: **statutory law** and **common law**.

A **statute** is a law passed by a legislature; and **statutory law** is the body of law resulting from statutes. A statute—or the statutory law—may also be referred to as **legislation**. One of the benefits of statutory law is that whether it's federal or state law, it's a written law that you can locate and read at the law library or online. This is not true of common law, which is also known as "unwritten law, because it's not collected in a single source.

Suppose you are headed over to a friend's house to watch football on Sunday, and on your way you stop in at the local supermarket to buy some beer and pretzels for the gang. You carry your six-pack and snacks up to the counter to pay, and the clerk tells you that she's sorry, but she can't sell you the beer. At first you think it's because she suspects you're underage, but before you can show her your ID, she explains that she can't sell alcohol before noon because (1) it's Sunday and (2) you are in the State of North Carolina. Shocked, you think she's joking until she refers you to the following NC Statute: N.C. General Statute 18B-1004(c) states, "It shall be unlawful to sell or consume alcoholic beverages on any licensed premises from the time at which sale or consumption must cease on Sunday morning until 12:00 noon on that day." No amount of begging or pleading will get you the beer, because the owner of the supermarket knows that if she violates N.C. General Statute 18B-1004(c), the store's ABC license could be revoked and its alcohol sales ended *permanently*. This is an example of statutory law.

However, when the federal and state constitutions were written, it wasn't possible to anticipate and include every possible law in those documents. For instance, in 1789 there was no reason to write laws prohibiting people from operating motor vehicles while intoxicated, because there were no motor vehicles yet—people still rode horses. Instead, the Constitution made provisions for law to evolve as society evolved. In 1803, U.S. Supreme Court Chief Justice John Marshall stated that "[i]t is emphatically the province and duty of the Judicial Department to say what the law is." This kind of judge-made law is **common law**. Case law is developed by judges, courts, and similar tribunals, and, over time, the decisions in individual cases establish precedents for future cases. **Precedent** means that the decisions judges have made in earlier cases guide how future cases are decided. In common law systems, this principle is called **stare decisis**, and it has a binding effect on judges and courts: Stare decisis holds that cases should be decided according to consistent principled rules so that similar facts will yield similar results. If the court finds that the current dispute is fundamentally distinct from previous cases, judges have the authority and duty to make law by creating precedent. Thereafter, the new decision becomes precedent and will bind future courts.

William Frantz Elementary School, New Orleans, 1960. "After a Federal court ordered the desegregation of schools in the South, U.S. marshals escorted a young Black girl, Ruby Bridges, to school."

In *Brown v. Board of Education*, the landmark case concerning racial segregation in U.S. public schools, the Supreme Court ultimately handed down a decision that established a new legal precedent. At the heart of the case was the contention that the separate school systems for blacks and whites were inherently unequal and thus violated the Equal Protection Clause of the Fourteenth Amendment to the U.S. Constitution.

After the case was reheard in 1953, Chief Justice Warren was able to persuade all of the justices to support a unanimous decision declaring segregation in public schools to be unconstitutional. On May 14, 1954, he delivered the opinion of the Court: "We conclude that in the field of public education the doctrine of 'separate but equal' has no place. Separate educational facilities are inherently unequal. . ."

Although it would be many years before all U.S. public schools were desegregated, the Supreme Court's ruling in *Brown* was the legal turning point that paved the way for the this change. Under common law, the precedent it established was that separate educational facilities for different races are inherently unequal.

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5.4: Tort Law

What you'll learn to do: define tort law, and explain the role of product liability in tort law

In this section you'll learn about an area of the law that's especially important for business: tort law and product liability.

Learning Objectives

- Explain the concept of negligence as it relates to tort law
- Explain the three major bases for product liability claims
- Differentiate between compensatory and punitive damages

Tort Law

In common law jurisdictions, a **tort** is a civil wrong that unfairly causes someone else to suffer loss or harm, resulting in legal liability for the person who commits the tortious act. Although crimes may be torts, the cause of legal action is not necessarily a crime, as the harm may be due to negligence. The following video explains what **negligence** is.

The victim of the harm can recover his or her loss as damages in a lawsuit. In order to prevail, the plaintiff in the lawsuit, commonly referred to as the injured party, must prove that a breach of duty (i.e., either an action or lack of action) was the legally recognizable cause of the harm.

Legal injuries are not limited to physical injuries and may include emotional, economic, or reputational injuries, as well as violations of privacy, property, or constitutional rights. Torts include such varied topics as auto accidents, false imprisonment, defamation, product liability, copyright infringement, and environmental pollution (toxic torts). While many torts are the result of negligence, tort law also recognizes intentional torts, in which a person has intentionally acted in a way that harms another. In addition, when it comes to product liability, the courts have established a doctrine of "strict liability" for torts arising from injury caused by the use of a company's product and/or service. Under "strict liability," the injured party does not have to prove that the company was negligent in order to win a claim for damages.

Tort law is different from criminal law in two ways: (1) torts may result from negligent as well as intentional or criminal actions, and (2) tort lawsuits have a lower burden of proof, such as "preponderance of evidence" rather than "beyond a reasonable doubt." Sometimes a plaintiff may prevail in a tort case even if the person who allegedly caused harm was acquitted in an earlier criminal trial. For example, O. J. Simpson was acquitted in criminal court of murder but later found liable for the tort of wrongful death.

For businesses, torts that arise from product liability can have devastating consequences. Let's examine product liability in greater detail.

Product Liability

Product liability is the area of law in which product manufacturers, distributors, and sellers are held responsible for the injuries caused by their products. Traditionally, product liability cases were decided according to the theory of **negligence**. Negligence is behavior that results in an unintentional injury or causes unintentional harm. Product liability law has evolved, however, and most states have extended product liability into the category of strict liability tort, too. **Strict liability torts** involve actions that are inherently dangerous and for which a party *may be liable no matter how carefully he or she (or it) performs those actions*. Regardless of whether the product liability claim is based upon negligence or strict liability, a product liability claim results from either a design defect, a manufacturing defect, or a failure to warn. To better appreciate the issues involved in cases of strict liability, let's return to where we left you and your summer house-painting business at the beginning of this module.

Having escaped the house-painting business relatively unscathed, you head back home to rethink your options for gainful employment during your summer vacation. You've stored your only remaining capital assets—the two ladders and the platform that you'd used for scaffolding—in your father's garage. One afternoon, your uncle notices them.

Examining one of the ladders, he asks you how much weight it's designed to hold, and you tell him what the department manager at Ladders 'n' Things told you: three hundred pounds per rung. Sensing that he might want to buy them, you hasten to add that, although you got them at a cut-rate price because of a little rust, they're virtually brand-new. As it turns out, your uncle doesn't want to buy the ladders, but he does offer to pay you $35 an hour to take them to his house and help him put up new roofing. He's easygoing, he's family, and he probably won't sue you for anything, so you jump at the opportunity.

Everything goes smoothly until day two, when you're working on the scaffolding two stories off the ground. In the process of unwrapping a bundle of shingles, one of the ladders buckles, and the entire platform comes down—landing you on your uncle's stone patio with a cervical fracture.

Fortunately, there's no damage to your spinal cord, but you're in pain and you need surgery. Now it's your turn to sue somebody. But whom? And for what?

Pursuing a Claim of Product Liability

Not surprising, your lawyer advises you to file an action for product liability—a claim of injury suffered because of a defective product (in your case, the ladder, of course). He goes on to say that in cases of product liability, there are three major bases for product liability claims. Section 2 of the *Restatement (Third) of Torts: Products Liability* identifies the following: manufacturing defect, design defect, failure to warn (also known as marketing defects). These are explained below:

- **Manufacturing defects** are those that occur in the manufacturing process and usually involve poor-quality materials or shoddy workmanship.
- **Design defects** occur where the product design is inherently dangerous or useless (and hence defective) no matter how carefully manufactured; this may be demonstrated either by showing that the product fails to satisfy ordinary consumer expectations as to what constitutes a safe product or that the risks of the product outweigh its benefits.
- **Failure-to-warn defects** arise in products that carry inherent non-obvious dangers that could be mitigated through adequate warnings to the user, and these dangers are present regardless of how well the product is manufactured and designed for its intended purpose.

In most states, these defects are not legal claims in and of themselves, but they are the grounds for the action (negligence or strict liability). For example, a plaintiff might plead negligent failure to warn or strict liability for defective design.

Grounds of Strict Liability

For the sake of argument, let's say that your lawyer isn't very confident about pursuing a claim of negligence against the manufacturer of your ladder. The company doesn't appear to have been careless in any of the three forms prescribed by law, and it will in any case be difficult to demonstrate the elements required in negligence cases. He suggests instead that you proceed on grounds of strict liability.

In tort law, **strict liability** is the imposition of liability on a party without a finding of fault (such as negligence or tortious intent). The claimant need only prove that the tort occurred and that the defendant was responsible. The law imputes strict liability to situations it considers to be inherently dangerous. It discourages reckless behavior and needless loss by forcing potential defendants to take every possible precaution. It also has the effect of simplifying and thereby expediting court decisions in these cases. In short, strict liability is based on the following legal theories:

1. Certain products put people at risk of injury no matter how much care is taken to prevent injury.
2. Consumers should have some means of seeking compensation if they're injured while using these products.

A classic example of strict liability is the owner of a tiger rehabilitation center. No matter how strong the tiger cages are, if an animal escapes and causes damage and injury, the owner is held liable. Another example is a contractor hiring a demolition subcontractor that lacks proper insurance. If the subcontractor makes a mistake, the contractor is strictly liable for any damage that occurs.

In strict liability situations, although the plaintiff does not have to prove fault, the defendant can raise a defense of "absence of fault": that is, the defense can argue that the defect was the result of the *plaintiff's actions*—not of the product—and that no inference of defect should be drawn solely because an accident occurs. On the other hand, if the plaintiff can prove that the defendant *knew* about the defect before the damages occurred, in some jurisdictions additional punitive damages can be awarded to the victim.

Compensatory and Punitive Damages

When someone pursues a claim under a tort, the goal (or legal remedy) is usually the award of damages. Damages in tort are generally awarded to restore the plaintiff to the position he or she was in had the tort not occurred.

In law, **damages** are an award, typically of money, to be paid to a person as compensation for loss or injury. Damages are classified as **compensatory** (or **actual**) **damages** and **punitive damages**. Compensatory damages are further categorized into **special damages**, which are economic losses such as loss of earnings, property damage, and medical expenses, and **general damages**, which are noneconomic damages such as pain and suffering and emotional distress.

Generally, punitive damages are not awarded in order to compensate the plaintiff but to reform or deter the defendant and similar persons from pursuing a course of action such as that which damaged the plaintiff. Punitive damages are awarded only in special cases where a defendant acted in a blatantly negligent, malicious, or grossly reckless manner.

In the case of *Liebeck v. McDonald's Restaurants* (1994), for example, 79-year-old Stella Liebeck spilled McDonald's coffee in her lap, which resulted in second- and third-degree burns on her thighs, buttocks, groin, and genitals. The burns were severe enough to require skin grafts. Liebeck attempted to have McDonald's pay her $20,000 medical bills as indemnity for the incident. McDonald's refused, and Liebeck sued. During the case's discovery process, internal documents from McDonald's revealed that the company had received hundreds of similar complaints from customers claiming that McDonald's coffee caused severe burns. At trial, this led the jury to find that McDonald's knew their product was dangerous and injuring their customers and that the company had done nothing to correct the problem. The jury decided on $200,000 in *compensatory damages*, but attributed 20 percent of the fault to Liebeck, reducing her compensation to $160,000. The jury also awarded Liebeck $2.7 million in *punitive damages*, which, at the time, represented two days' of McDonald's coffee sales revenue. The judge later reduced the punitive damages to $480,000. The case is often criticized for the very high amount of damages the jury awarded.

The following videos also explain compensatory and punitive damages.

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5.5: Intellectual Property

What you'll learn to do: explain the purpose and characteristics of intellectual property law

In this section we'll discuss the importance of intellectual property law and explain what is covered by it.

Learning Objectives

- Explain patents
- Explain trademarks

Intellectual Property

Patent pending: Solar Puff is a solar-powered inflatable light that was designed to provide an affordable and renewable light source to disaster-relief victims. The light uses the principles of origami and foldable design to "pop" open from a flat envelope into a cube.

To this point we have discussed laws governing people and things, but what about laws protecting knowledge or ideas?

The notion that knowledge is valuable goes back to ancient times. In the 1st century AD, Juvenal (55–130) observed, "All wish to know but none wish to pay the price." However, the value of knowledge in an economic or business sense—knowledge recognized as a type of asset or property that one might wish to protect—is much more recent, dating back to the seventeenth century or so (the Statute of Monopolies [1624] and the British Statute of Anne [1710] are seen as firmly establishing the concept of "intellectual property"). Since then, a special body of law concerning the protection of knowledge and ideas has developed. Known as intellectual property law, these laws cover intangible assets such as patents, trademarks, and copyright.

What Is Intellectual Property?

The term **intellectual property** refers to creations of the mind—creative works or ideas embodied in a form that can be shared or enable others to recreate, emulate, or manufacture them. There are three main ways to protect intellectual property: patents, trademarks, and copyrights.

Patents protect inventions and improvements to existing inventions for a limited period of time in exchange for detailed public disclosure of those inventions.

Trademarks include any word, name, symbol, or device, or any combination, used, or intended to be used in commerce to identify and distinguish the goods of one manufacturer or seller from goods manufactured or sold by others, and to indicate the source of the goods. **Service marks** include any word, name, symbol, device, or any combination, used, or intended to be used, in commerce, to identify and distinguish the services of one provider from services provided by others, and to indicate the source of the services.

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According to Cornell University Law School, "intellectual property is any product of the human intellect that the law protects from unauthorized use by others." Take a look at the following video to learn more about what intellectual property is and why it matters.

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5.6: Warranties

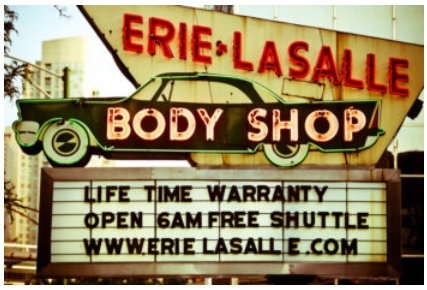
What you'll learn to do: describe warranties

In this section you will learn about the different types of warranties that are attached to the goods and services that businesses provide.

Learning Objectives

- Explain express warranties
- Explain the warranties provided by the Uniform Commercial Code

Warranties



A **warranty** is a guarantee or promise that provides assurance by one party to another party that specific facts or conditions are true or will happen. Some warranties run with a product, such that a manufacturer makes the warranty to a consumer with whom the manufacturer has no direct relationship. For example, your iPhone came with a warranty, but the people at Apple don't know who you are. This fact doesn't negate the warranty that came with your phone, though. A warranty may be express or implied, depending on whether the warranty is explicitly provided (typically written).

Types of Warranties

Express Warranties

Express warranties are just that—expressed in writing. When you purchased a new television set, for example, somewhere among all of the instructions on how to connect it to your Blue-Ray player and Wi-Fi and XBox was a small card that expressly stated what warranty the manufacturer was providing to you as the purchaser.

Implied Warranties

Implied warranties are unwritten promises that arise from the nature of the transaction and the inherent understanding by the buyer rather than from the express representations of the seller. In the United States, the Uniform Commercial Code provides that the following two warranties are implied unless they are explicitly disclaimed (such as an "as is" statement):

- The **warranty of merchantability** is implied unless expressly disclaimed or the sale is identified with the phrase "as is." To be "merchantable," the goods must reasonably conform to an ordinary buyer's expectations. For example, a fruit that looks and smells good but has hidden defects may violate the warranty if its quality does not meet the standards for such fruit "as passes ordinarily in the trade."
- The **warranty of fitness for a particular purpose** is implied unless disclaimed when a buyer relies upon the seller to select the goods to fit a specific request. For example, this warranty is violated when a buyer asks a mechanic to provide tires for use on snowy roads and receives tires that are unsafe to use in snow.

The following video explains one's legal rights under implied warranties.

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5.7: Contracts

What you'll learn to do: list and describe the elements of a legally enforceable contract, and explain the consequences of breach of contract

The contract is probably the most familiar legal concept in American society because it's so central to deeply held convictions about the nature of our political, economic, and social life. In this section you'll learn what contracts are and why they're so central to business.

Learning Objectives

- Identify the four elements of a legally enforceable contract
- Explain the legal remedies for breach of contract

What Is a Contract?

A **contract** is a voluntary arrangement between two or more parties that is enforceable as a binding legal agreement.

A contract arises when the parties concur that there is an agreement. Formation of a contract generally requires an offer, acceptance, consideration, and a mutual intent to be bound. Each party to a contract must have capacity to enter the agreement. Minors, intoxicated persons, and those under a mental affliction may have insufficient capacity to enter a contract.

A contract may be oral or written, and the lack of a writing does not automatically make the contract void. English law and later U.S. law, however, recognized that oral contracts were subject to fraudulent claims by unscrupulous parties, and so developed the "Statute of Frauds" requiring that certain types of contracts be put into writing in order to be enforceable.

Under U.S. law, a contract must have four essential elements in order to be valid:

1. Offer and Acceptance
2. Consideration
3. Competent Parties
4. Legal Purpose

The following video explains these requirements in greater detail.

Breaches of Contracts

We speak of contracts as being either enforceable (legally binding) or unenforceable. An enforceable contract creates legal obligations, and the failure to comply with them creates a breach of contract.

When a party fails to live up to its obligations under the contract, he is said to have breached the agreement or to be in **breach of contract**. In the case of a breach of contract, the party that has suffered as a result of the breach may be granted one or more of the following remedies:

1. **Specific Performance**. In some circumstances a court will order a party to perform his or her promise under the contract. In this case, the court will make an order of what is called "specific performance," requiring that the contract be performed. There may be circumstances in which it would be unjust to permit the defaulting party simply to buy out the injured party with damages—for example, if an art collector purchased a rare painting and the vendor refused to deliver, the collector's damages would be equal to the sum paid, but that wouldn't exactly be just, since the contracted stipulated receipt of the painting.
2. **Damages**. Damages may be general or consequential. **General damages** are those damages that naturally flow from a breach of contract. **Consequential damages** are those damages that, although not naturally flowing from a breach, are naturally supposed by both parties at the time of contract formation. An example would be when someone rents a car to get to a business meeting, but when that person arrives to pick up the car, it isn't there. General damages would be the cost of renting a different car. Consequential damages would be the business lost if that person were unable to get to the meeting, if both parties knew the reason the party was renting the car. However, there is still a duty to mitigate the losses. The fact that the car wasn't there doesn't give the party a right not to attempt to rent another car.
3. **Discharge of Duties.** There are some instances when, after the breach, both parties are relieved of their obligations under the contract. Let's say you enter into a contract to purchase a house, but the house is destroyed by a tornado before you can complete the purchase. In this case, the court may decide that since the house is no longer there, the best remedy is to discharge the contract and relieve both parties of their obligation to perform under the contract.

Since almost every exchange in business creates some form of contract, it is essential that business owners as well as consumers understand the fundamental principles of contracts and contract laws.

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5.8: Putting It Together- Legal Environment

Synthesis

Now that you have studied the legal environment of business, let's go back and check on your roommate. What do you think the outcome of the lawsuit was?

You probably won't be surprised to learn that your roommate was liable for negligence in kicking over the paint bucket, but you may be dismayed to learn that you were, too. When it comes to the claim of assault and battery, your roommate was also liable for that, but you may be protected from liability. As for the damages that you'll have to pay in order to settle the homeowner's negligence suit, you'll be happy to know that you can indeed write them off as "ordinary" business expenses (unless they're paid by your insurance company).

After working through this module you should be aware that even after paying damages, you still fared better than your roommate, because assault and battery violates statutes established by two different types of law—criminal and civil.

It is incumbent on each business professional to become familiar with the legal environment in his or her profession. Employers may provide training regarding legal environment issues, such as anti-sexual-harassment training or anti-insider-trading training, but ultimately, becoming familiar with the legal environment is each person's individual responsibility. Remember that a defense of "I didn't know the law!" is no defense at all.

Summary

This module covered the legal environment of business. Below is a summary of the topics covered in this module.

The Meaning and Purpose of Law

The law as we defined it is a set of rules of conduct or procedure established by custom, agreement, or authority. It refers to the entire the body of rules and principles governing the affairs of a community and enforced by a political authority. The main purposes of the law are to establish standards, maintain order, resolve disputes, and protect liberties and rights.

Statutory and Common Law

There are different sources of law in the U.S. legal system. The U.S. Constitution is foundational; U.S. statutory and common law must be consistent with its provisions. Congress creates statutory law (with the signature of the president), and the courts interpret both statutory and constitutional law. Where there is neither constitutional law nor statutory law, the courts function in the realm of common law.

Tort Law

In common law jurisdictions, a tort is a civil wrong that unfairly causes someone else to suffer loss or harm, resulting in legal liability for the person who commits the tortious act. Torts may result from negligent as well as intentional or criminal actions.

Product liability is the area of law in which product manufacturers, distributors, and sellers are held responsible for the injuries caused by their products.

When someone pursues a claim under a tort, the goal (or legal remedy) is usually the award of damages. Damages are an award, typically of money, to be paid to a person as compensation for loss or injury.

Intellectual Property

Intellectual property refers to creations of the mind—creative works or ideas embodied in a form that can be shared or enable others to recreate, emulate, or manufacture them. There are three main ways to protect intellectual property: patents, trademarks, and copyrights.

Warranties

A first basis of recovery in products-liability theory is breach of warranty. There are two types of warranties: express and implied. Under the implied category are three major subtypes: the implied warranty of merchantability (only given by merchants), the implied warranty of fitness for a particular purpose, and the implied warranty of title. Under warranty law there must have been a sale of the goods; the plaintiff must bring the action within the statute of limitations; and the plaintiff must notify the seller within a reasonable time. The seller may limit or exclude express warranties or limit or exclude implied warranties.

Contracts

Every transaction in business creates a contract (agreement) between the parties. In order to determine whether a valid, enforceable contract exists, the following questions must be answered: (1) Did the parties reach an agreement? (2) Was consideration present? (3) Was the agreement legal? (4) Did the parties have capacity to make a contract? (5) Was the agreement in the proper form? Remedies available against someone who breaches a contract include damages, specific performance, and restitution. Frequently the party who is not in breach must choose between tort and contract remedies.

Consumer Protection and Antitrust Laws

A range of laws regulate consumer affairs, and their aim is to protect consumers from unscrupulous business practices or potentially dangerous products. Some of the most far-reaching consumer protection laws are the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Federal Food, Drug, and Cosmetics Act, and the Uniform Deceptive Trade Practices Act.

Antitrust legislation is another kind of consumer protection that aims to prevent unfair business practices that limit competition or control prices. The three core federal antitrust laws are the Sherman Act, the Federal Trade Commission Act, and the Clayton Act.

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5.9: Consumer Protection and Antitrust Laws

What you'll learn to do: summarize consumer protection and antitrust laws

In this section you'll learn why consumer protection and antitrust laws are needed and what they're intended to do.

Learning Objectives

- Summarize several consumer protection laws
- Summarize the provisions of the Sherman Act
- Summarize the provisions of the Clayton Act

Consumer Protection

Consumers and Choice

A consumer can be broadly defined as a person who needs, uses, or has used a particular service or product. In this sense, we are all consumers. Consumers make up the largest economic group, affecting and affected by almost every public and private economic decision. Yet often their views are not heard.

Individual consumers tend to be dispersed, while producers and traders can be organized and powerful, with greater access to information. Consumers are therefore more vulnerable to exploitation through deceptive advertising and selling, provision of substandard, fake, and adulterated products, predatory loans and fraudulent, unethical, and monopolistic trade practices. This can result in not only poor value for money, which undermines welfare and efficiency, but also present risks to health and safety. Children, elderly people, disabled people, the poor, uneducated, and illiterate are particularly vulnerable.

The principle of *caveat emptor* ("buyer beware") is not sufficient, and consumers need specific protections, and the rights to safety, choice, information, and redress. Consumer protection supports economic prosperity, as it enables honest and efficient businesses to compete, and it helps consumers make the best use of resources.

The choices people make as consumers can affect their health, safety, welfare, and financial security, and that of those around them and the wider environment. Choices also offer a means by which people can influence society. Demographic changes, economic growth, international trade, and technology innovation are opening up new opportunities for consumer welfare, but they're are also creating new challenges. Enabling people to be informed and active consumers is critical to developing a participative, critical, and competent citizenship.

Consumer Protection Legislation

Consumer protection laws often mandate the posting of notices such as this one, which appears in all automotive repair shops in California.

In the United States a range of laws at both the federal and state levels regulate consumer affairs. Federal consumer protection laws are mainly enforced by the Federal Trade Commission, the Consumer Financial Protection Bureau, the Food and Drug Administration, and the U.S. Department of Justice. The function of such legislation is to protect consumers from unscrupulous business practices or potentially dangerous products. Several of the most far-reaching pieces of consumer protection legislation are discussed below.

The **Fair Credit Reporting Act** is U.S. Federal Government legislation enacted to promote the accuracy, fairness, and privacy of consumer information contained in the files of consumer reporting agencies. It was intended to protect consumers from the willful and/or negligent inclusion of inaccurate information in their credit reports. To that end, the FCRA regulates the collection, dissemination, and use of consumer information, including consumer credit information. Together with the Fair Debt Collection Practices Act ("FDCPA"), the FCRA forms the foundation of consumer rights law in the United States. It was originally passed in 1970 and is enforced by the U.S. Federal Trade Commission and the Consumer Financial Protection Bureau.

The **Fair Debt Collection Practices Act (FDCPA)**, is a consumer protection amendment to the Consumer Credit Protection Act, establishing legal protection from abusive debt collection practices. The statute's stated purposes are to eliminate abusive practices

in the collection of consumer debts, to promote fair debt collection, and to provide consumers with an avenue for disputing and obtaining validation of debt information in order to ensure the information's accuracy. The act creates guidelines under which debt collectors may conduct business, defines rights of consumers involved with debt collectors, and prescribes penalties and remedies for violations of the act.

The United States **Federal Food, Drug, and Cosmetics Act** is a set of laws passed by Congress in 1938 giving authority to the U.S. Food and Drug Administration (FDA) to oversee the safety of food, drugs, and cosmetics. It covers everything from food coloring (Red Dye #6) to bottled water, homeopathic remedies, and medical devices.

At the state level, many states have adopted the **Uniform Deceptive Trade Practices Act.** This statute allows local prosecutors or the attorney general to press charges against people who knowingly use deceptive business practices in a consumer transaction, and it authorizes consumers to hire a private attorney to bring an action seeking their actual damages, punitive damages, and attorney's fees. The deceptive trade practices prohibited by the Uniform Act can be roughly subdivided into conduct involving the following:

1. unfair or fraudulent business practice and
2. untrue or misleading advertising.

Also, the majority of states have a **Department of Consumer Affairs** devoted to regulating certain industries and protecting consumers who use goods and services from those industries. For example, in California, the California Department of Consumer Affairs regulates about 2.3 million professionals in more than 230 different professions, through its forty regulatory entities. In addition, California encourages its consumers to act as private attorneys general through the liberal provisions of its Consumers Legal Remedies Act. Other states have been the leaders in specific aspects of consumer protection. For example, Florida, Delaware, and Minnesota have legislated requirements that contracts be written at reasonable readability levels, because a large proportion of contracts cannot be understood by most consumers who sign them.

Antitrust Legislation

Antitrust legislation is essentially another type of consumer protection. The goal of such legislation is to protect consumers against unfair business practices that limit competition or control prices. In 1890, Congress passed the first antitrust law, the Sherman Act, as a "comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade." In 1914, Congress passed two additional antitrust laws: the Federal Trade Commission Act, which created the FTC, and the Clayton Act. With some revisions, these are the three core federal antitrust laws still in effect today.

The antitrust laws proscribe unlawful mergers and business practices in general terms, leaving courts to decide which ones are illegal based on the facts of each case. Courts have applied the antitrust laws to changing markets, from a time of horse and buggies to the present digital age. Yet for more than one hundred years, the antitrust laws have had the same basic objective: to protect the process of competition for the benefit of consumers, making sure there are strong incentives for businesses to operate efficiently, keep prices down, and keep quality up.

Here is an overview of the three core federal antitrust laws.

Sherman Act

The **Sherman Act** outlaws "every contract, combination, or conspiracy in restraint of trade," and any "monopolization, attempted monopolization, or conspiracy or combination to monopolize." Long ago, the Supreme Court decided that the Sherman Act does not prohibit every restraint of trade, only those that are *unreasonable*. For instance, in some sense, an agreement between two individuals to form a partnership restrains trade, but not necessarily unreasonably, and thus may be lawful under the antitrust laws. On the other hand, certain acts are considered so harmful to competition that they are almost always illegal. These include plain arrangements among competing individuals or businesses to fix prices, divide markets, or rig bids. These acts are "*per se*" violations of the Sherman Act; in other words, no defense or justification is allowed.

The penalties for violating the Sherman Act can be severe. Although most enforcement actions are civil, the Sherman Act is also a criminal law, and individuals and businesses that violate it may be prosecuted by the Department of Justice. Criminal prosecutions are typically limited to intentional and clear violations such as when competitors fix prices or rig bids. The Sherman Act imposes criminal penalties of up to $100 million for a corporation and $1 million for an individual, along with up to ten years in prison. Under federal law, the maximum fine may be increased to twice the amount the conspirators gained from the illegal acts or twice the money lost by the victims of the crime, if either of those amounts is more than $100 million.

Federal Trade Commission Act

The **Federal Trade Commission Act** bans “unfair methods of competition” and “unfair or deceptive acts or practices.” The Supreme Court has said that all violations of the Sherman Act also violate the FTC Act. Thus, although the FTC does not technically enforce the Sherman Act, it can bring cases under the FTC Act against the same kinds of activities that violate the Sherman Act. The FTC Act also reaches other practices that harm competition but that may not fit neatly into categories of conduct formally prohibited by the Sherman Act. Only the FTC brings cases under the FTC Act.

Clayton Act

The **Clayton Act** addresses specific practices that the Sherman Act does not clearly prohibit, such as mergers and interlocking directorates (that is, the same person making business decisions for competing companies). Section 7 of the Clayton Act prohibits mergers and acquisitions where the effect “may be substantially to lessen competition, or to tend to create a monopoly.” As amended by the Robinson-Patman Act of 1936, the Clayton Act also bans certain discriminatory prices, services, and allowances in dealings between merchants. The Clayton Act was amended again in 1976 by the Hart-Scott-Rodino Antitrust Improvements Act to require companies planning large mergers or acquisitions to notify the government of their plans in advance. The Clayton Act also authorizes private parties to sue for triple damages when they have been harmed by conduct that violates either the Sherman or Clayton Act and to obtain a court order prohibiting the anticompetitive practice in the future.

In addition to these federal statutes, most states have antitrust laws that are enforced by state attorneys general or private plaintiffs. Many of these statutes are based on the federal antitrust laws.

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CHAPTER OVERVIEW

6: Business Ethics and Corporate Social Responsibility

6.1: Why It Matters- Business Ethics and Corporate Social Responsibility
6.2: Ethical and Legal Behavior
6.3: Business Ethics
6.4: Ethical Challenges
6.5: Corporate Social Responsibility
6.6: Putting It Together- Business Ethics and Corporate Social Responsibility

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6.1: Why It Matters- Business Ethics and Corporate Social Responsibility

Why explain the importance of business ethics and corporate social responsibility?

The car company Volkswagen (which is part of the larger Volkswagen Group) indicates that its goal is "to offer attractive, safe, and environmentally sound vehicles that can compete in an increasingly tough market and set world standards in their respective class."[1]

In September 2015, the Environmental Protection Agency announced that Volkswagen had installed special software in its cars to manipulate emissions levels (making it appear that the cars are less polluting than they are). A week later, Volkswagen disclosed that 11 million diesel vehicles contained the devices, and CEO Martin Winterkorn resigned. The price of Volkswagen stock plunged—losing 30 percent of its value overnight—and the company scrambled to understand what had happened and control the damage to its reputation.

In the months following the discovery of the deceptive devices, investigators identified a team of Volkswagen employees who had hatched the plan and implemented it over a number of years. An internal evaluation identified a "culture of tolerance" for rule breaking at the company. It also came to light that Volkswagen's emphasis on "results at any cost" had contributed to the breach in ethical standards. Industry experts believe that the company's violation of consumers' trust will be will be exceedingly difficult to repair and that it may take years to rebuild the Volkswagen brand.

In this module you'll learn why business ethics and corporate social responsibility are not just means of "doing the right thing" but in many cases are good business, too.

1. http://www.strategicmanagementinsigh...statement.html ↵

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6.2: Ethical and Legal Behavior

Learning objectives

- Define legal behavior
- Differentiate between ethical and legal behavior

to hire or not to hire smokers: that is the question at american express

American Express, a financial services company, found that smokers were costing the company $5,000–$6,000 more per year than nonsmokers. With medical costs rising 10 percent–15 percent per year, the board of directors wants to discuss whether the company should refuse to hire smokers.

Nationwide, about 6,000 companies refuse to hire smokers. Costs are driving the trend not to hire smokers. According to the CDC, a smoker will have 50 percent higher absenteeism and, when present, will work 39 fewer minutes per day because of smoke breaks, which leads to 1,817 lost hours of annual productivity. A smoker will have higher accident rates, cause $1,000 a year in property damage (from cigarette burns and smoke damage), and will cost up to $5,000 more a year for annual insurance premiums.

Few people would fault a company for trying to control costs and maintain a productive workforce, but the question is how far should a company go in pursuit of these goals? Law professor Don Garner believes that "If someone has the ability to do the job, he should get it. What you do in your home is your own business." Others say such policies set a dangerous precedent. "These things are extremely intrusive," said George Koodray, assistant U.S. director of the Citizens Freedom Alliance. If companies begin by discriminating against smokers, they might next discriminate against people who are overweight in order to cut costs.

As a manager, you have a hard decision regarding such a policy because your choice has implications beyond hiring decisions.

- On what basis should the company decide whether or not to hire smokers: the best interest of the firm, what the law allows, or individual rights?
- As a manager you have to consider both ethics and social responsibility. Ethical decision making is concerned with doing right and avoiding wrong. Social responsibility is a broader goal to pursue policies that benefit society. Should you protect an individual's right to smoke if it places a burden on society? Is it ethical to promote society's rights if it infringes on the rights of the individual?
- The board is charged with increasing shareholder wealth, so they particularly want a decision that's in the best interest of the company's financial health. Do you promote shareholders interests over those of the individual or society?

If you were in charge at American Express, what would you do?

This scenario enables us to explore fundamental questions about the nature of ethical and legal behavior in business. It also highlights the tension between our ideals and how they play out in the real world. Sometimes, acting in ways that are ethical and legal are one and the same thing. Other times, they are not.

Ethical Behavior

Ethics are a set of standards that govern the conduct of a person, especially a member of a profession. While ethical beliefs are held by individuals, they can also be reflected in the values, practices, and policies that shape the choices made by decision makers on behalf of their organizations[1]. Professions and organizations regularly establish a "Code of Ethics" that serves to guide the behavior of members of the profession or organization. In the medical profession, for instance, doctors take an ethical oath to "do no harm." The American Society of Mechanical Engineers' code states, "Engineers shall hold paramount the safety, health, and welfare of the public in the performance of their professional duties."

Legal Behavior

Legal behavior follows the dictates of laws, which are written down and interpreted by the courts. In decision making, determining the legality of a course of action is facilitated by the existence of statutes, regulations, and codes. Unlike ethical considerations, there are established penalties for behaving in a way that conflicts with the law. However, as society evolves, what constitutes legal

behavior also changes. For example, until recently, the possession or use of marijuana was illegal in the State of Colorado. As a result of the legislation that legalized marijuana, existing laws will need to be reinterpreted, and undoubtedly additional laws will be enacted to govern what was formerly illegal behavior. Whether or not an individual thinks it is ethical to use a potentially harmful substance, the fact is that the law now allows such behavior.

American Express

Using these as working definitions, let's return to American Express.

Ethical Considerations

If the company decides not to hire smokers, then the company would essentially be interfering with the individual's right to engage in a legal activity. If the company dictates to employees about smoking, what else can they decide for employees? The National Institute for Health reports that the aggregate national cost of overweight and obesity combined was $113.9 billion. Does the company set Body Mass Index (BMI) limits for potential employees to reduce the cost of medical coverage for obesity-related illness? As you can see, such decisions are complex—and, some would say, a slippery slope.

Legal Considerations

Would American Express's decision not to hire smokers constitute lifestyle discrimination? A company can require that employees not smoke during their shift or anywhere on company premises, but does it have the right to require them not to smoke when not at work or not on company property? According to the ACLU, it can become lifestyle discrimination if the company requires that employees not smoke when they're not at work, off duty, and/or off work premises. In fact, smokers are protected from employment-based discrimination in at least two dozen states.[2]. More than half of the states in the U.S. protect employees against employers who impose certain lifestyle requirements, such as only hiring non-smokers or refusing to hire individuals who are obese or have high cholesterol. Clearly American Express is dealing with a legal issue when considering the non-smoker policy, but as with the ethical issue, it's not cut and dried.

If you were in charge at American Express, what would you do?

As this example shows, people take positions and make choices within different frameworks, and those frameworks, while overlapping, are not always perfectly aligned. The legal framework establishes laws that govern behavior while the ethical framework contains sets of standards and rules governing the behavior of individuals within groups or professions.

As you will see in the rest of this module, when businesses try to "do the right" thing—by the law, by their shareholders, by their employees, by their customers, and other stakeholders—there is often a complex interplay of ethical and legal considerations.

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1. Source: Boundless. "Defining Ethics." Boundless Management. Boundless, 20 Sep. 2016. Retrieved 01 Dec. 2016 from www.boundless.com/management...hics-446-8310/ ↵
2. Mirabella, L. (2014). In Maryland, smoking could cost you job. Retrieved October 12, 2016, from www.baltimoresun.com/business...705-story.html ↵

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6.3: Business Ethics

Learning Objectives

- Explain how ethics relates to the business and the individual
- Explain the role of managers in setting standards for ethical behavior

Building Business Ethics

Governments use laws and regulations to point business behavior in what they perceive to be beneficial directions. **Business ethics** implicitly regulates behavior that lies beyond governmental control. Business ethics refers to contemporary standards or sets of values that govern the actions and behavior of individuals in the business organization and the actions of the business itself. It applies to all aspects of business conduct and is relevant to the conduct of individuals and entire organizations.[1] Corporations and professional organizations, particularly licensing boards, will usually have a written "Code of Ethics" that governs standards of professional conduct expected of all in the field.

Individual and Corporate Ethics

As the definition of business ethics above suggests, business ethics is a broad term that applies to the behavior of the individuals who work at a business as well as the actions of the business itself. There is a narrower term, "corporate ethics," that is used for this second area of the actions of a business. Corporate ethics express the values of an organization to its internal and external stakeholders. Corporate ethics has become such an important concern that companies such as Covalence EthicalQuote have cropped up to monitor the ethical behavior of businesses. These private firms track the world's largest companies in areas such as corporate social responsibility, ethics, and sustainability, and then provide ratings, news, and data to investors and the general public. Web sites such as Ethical Consumer promote "ethical consumerism" to help consumers act in the marketplace in ways that are consistent with their ethics. Year after year, companies such as Nestle, Bayer, and Monsanto grace the top of the "worst of the worst" lists.

But it's not all grim news or tattling when it comes to business ethics. For example, the Scottsdale, Arizona-based Ethisphere Institute—an organization focused on gauging ethical business practices—publishes a list of the "World's Most Ethical Companies" on an annual basis. The overall goal of Ethisphere's rankings is to reward organizations with good practices and offer a model—and actionable advice—on how corporate entities should conduct themselves, says chief marketing and strategy officer, Tia Smallwood. "The papers are filled with scandals and companies that made judgment errors, that made policy errors or that don't have good practices in place to handle things like non-retaliation or transparency or open reporting, or have had a crisis and handled it poorly," she said. "But there a lot of companies that are really trying to do things the right way." Notable call-outs this year are firms that have been honored every year of the list's existence. Those include Aflac, Fluor Corporation, GE, Kao Corporation (Japan), Milliken & Company, Starbucks and UPS.[2]

Encouraging Ethical Behavior

How, then, do businesses encourage and support ethical behavior? Often the ethical tone of a business is set by organizational leadership.

Consider the following observation by the Ethics and Compliance Initiative (ECI) on the results of the National Business Ethics survey:

> *"Managers – those expected to act as role models or enforce discipline–are responsible for a large share of workplace misconduct (60 percent) and senior managers are more likely than lower-level managers to break rules. Surveyed employees said that members of management are responsible for six of every ten instances of misconduct and they pointed the finger at senior managers in 24 percent of observed rule breaking. Middle managers were identified as the culprit 19 percent of the time and first-line supervisors were identified as bad actors 17 percent of the time.[3]"*

If a company is looking for ways to boost or ensuring ethical behavior in an organization, this is an interesting and alarming finding. In a supplemental report on Ethical Leadership, ECI reports that employees at all sizes of companies draw conclusions about their leaders' character primarily on the basis of the following:

- The overall character of their leaders as experienced through personal interactions;
- How senior managers handle crises; and
- The policies and procedures adopted by senior leaders to manage the company.

Employees want to know, for example, whether leaders treat lower level employees with dignity and respect, share credit when good things happen, and uphold standards even when it reduces revenues and profits. They watch to see whether leaders are steady in crisis, hold themselves accountable or, alternatively, shift blame to others. Workers also look at day-to-day management decisions to gauge whether ethical behavior is recognized and rewarded, or whether praise and promotions go to workers who bend the rules.[4]

These findings suggest the important role that executives play in building ethical organizations—ethics and integrity tend to start (or fail) at the top and trickle down.

The Role of Executives and Managers in Setting Ethical Standards

When executives establish specific, measurable objectives for the company, those objectives determine where people will focus their time and effort. When the objectives cannot be met and there are dire personal consequences for failure, such conditions can lead to the compromise of ethics and standards. In the National Business Ethics Survey, 70 percent of employees identified pressure to meet unrealistic business objectives as most likely to cause them to compromise their ethical standards, and 75 percent identified either their senior or middle management as the primary source of pressure they feel to compromise the standards of their organizations.

Former Volkswagon CEO, Martin Winterkorn is on the right

In the Volkswagen case, internal investigations have questioned how both the company culture and the behavior of former CEO Martin Winterkorn contributed to a systemic ethical breach. Like many chief executives, Martin Winterkorn was a demanding boss who didn't like failure, but critics say the pressure on managers at Volkswagen was unusual, which may go some way toward explaining the carmaker's crisis. When he became CEO in 2007, Winterkorn set an objective to make VW the world's biggest carmaker, which would require tremendous growth in the highly competitive U.S. car market. In the years since, VW has nearly doubled it global annual sales to 10 million cars and its revenue to $225 billion. In early 2015, VW finally approached its goal, selling marginally more vehicles than the world's number-one automaker, Toyota of Japan. One former sales executive said that the pressure soared under the target. "If you didn't like it, you moved of your own accord or you were performance-managed out of the business," he said.[5]

In describing a Winterkorn's leadership style, a former VW executive confidentially told Reuters New Agency, "There was always a distance, a fear and a respect . . . If he would come and visit or you had to go to him, your pulse would go up. If you presented bad news, those were the moments that it could become quite unpleasant and loud and quite demeaning."

A week after U.S. regulators revealed the company's cheating, Bernd Osterloh, the employee representative on VW's supervisory board, sent a letter to VW staff suggesting the change that was needed: "We need in the future a climate in which problems aren't hidden but can be openly communicated to superiors," said Osterloh. "We need a culture in which it's possible and permissible to argue with your superior about the best way to go."[6]

In *Fortune* magazine, Dr. Paul Argenti suggested, "Rather than playing the blame game, executives should ask if pressures to grow at all costs might have created dishonest employees."[7]

It seems likely that aggressive corporate objectives (and more specifically marketing objectives related to market share) played a contributing role in the Volkswagen ethics scandal. Moreover, when executives set aggressive goals, it becomes more important to cultivate communication channels to openly address issues. This was obviously not the case at Volkswagon.

Executives play an important role in creating company policies on ethics—and by visibly following and upholding them. As the survey data cited above suggest, employees look to executives to decide whether standards-of-business-conduct policies should be observed and respected. When executives bend the rules or turn a blind eye to bad behavior, the policies lose value and executives

lose the respect of employees. This opens the door to a range of unanticipated issues, as employees look to ethical norms outside stated policy and beyond the executives' control.

Internal promotions send very strong signals about what is important to a company. When the company hires an employee from a different company, she is likely not well known by most employees. If the company promotes an employee who is already working at the company, others know him and understand what he has done to deserve the promotion. If the company promotes individuals to management positions when they have displayed questionable ethics in the workplace, it creates two issues. First, it creates a level of managers who are more likely to encourage their employees to achieve business results at any cost, even when ethics are compromised. Second, it sends a message to all employees that business results are more important than ethics.

Company Codes of Ethics and Codes of Practice

An increasing number of companies requires employees to attend trainings regarding business conduct. These typically include discussions of the company's policies, specific case studies, and legal requirements. Some companies even require their employees to sign agreements stating that they will abide by the company's rules of conduct.

As part of more comprehensive compliance and ethics programs, many companies have formulated internal policies pertaining to the ethical conduct of employees. They are generally documented in one of two ways:

1. **Corporate Code of Ethics**. A code of ethics begins by setting out the values that underpin the code and describes a company's obligation to its stakeholders. The code is publicly available and addressed to anyone with an interest in the company's activities and the way it does business. It includes details of how the company plans to implement its values and vision, as well as guidance to staff on ethical standards and how to achieve them. It is hoped that having such a policy will lead to greater ethical awareness, consistency in application, and the avoidance of ethical disasters.
2. **Code of Practice.** A code of practice is adopted by a profession or by a governmental or nongovernmental organization to regulate that profession. A code of practice may be styled as a code of professional responsibility, and it will discuss difficult issues, difficult decisions that will often need to be made, and provide a clear account of what behavior is considered "ethical" or "correct" or "right" in the circumstances. In a membership context, failure to comply with a code of practice can result in expulsion from the professional organization.

Richard DeGeorge, author of *Business Ethics*, has this to say about the importance of maintaining a corporate code:

> *"Corporate codes have a certain usefulness and there are several advantages to developing them. First, the very exercise of doing so in itself is worthwhile, especially if it forces a large number of people in the firm to think through, in a fresh way, their mission and the important obligations they as a group and as individuals have to the firm, to each other, to their clients and customers, and to society as a whole. Second, once adopted, a code can be used to generate continuing discussion and possible modification to the code. Third, it could help to inculcate in new employees at all levels the perspective of responsibility, the need to think in moral terms about their actions, and the importance of developing the virtues appropriate to their position.[8]"*

Beyond establishing policies or codes that guide the ethical behavior of the company or employees, many companies are assessing the environmental factors that can lead employees to engage in unethical conduct. A competitive business environment may call for unethical behavior. For example, lying has become the norm in fields such as stock and security trading. Sometimes there is disconnection between the company's code of ethics and the company's actual practices. Thus, whether or not such conduct is explicitly sanctioned by management, at worst, this makes the policy duplicitous, and, at best, it is merely a marketing tool.

Not everyone supports corporate policies that govern ethical conduct. Some claim that ethical problems are better dealt with by relying upon employees to use their own judgment. Others believe that corporate ethics policies are primarily rooted in utilitarian concerns, and that they are mainly to limit the company's legal liability, or to curry public favor by giving the appearance of being a good corporate citizen. Ideally, the company will avoid a lawsuit because its employees will follow the rules. Should a lawsuit occur, the company can claim that the problem wouldn't have arisen if the employee had followed the code properly.

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6.4: Ethical Challenges

What you'll learn to do: identify common ethical challenges faced by organizations

In a perfect world, it's always clear what's right or wrong. In the real world, things are often not so clear. Someone's wrong can be your right, which means your right will definitely, at some point, be someone else's wrong. Most of the time, the "right" choice is subjective. In business, many of these ethical challenges appear in the form of bribes, conflicts of interest, issues of honesty and integrity, and whistle-blowing.

In this section you'll learn some of the special terms for particular kinds of unethical behavior in business.

Learning Objectives

- Define kickback
- Explain how whistleblowers can contribute to a company's ethical behavior
- Define bribery
- Give examples of unethical corporate or business behavior

Bribery and Kickbacks

Bribery is the act of giving money, goods, or other forms of compensation to a recipient in exchange for an alteration of their behavior (to the benefit/interest of the giver) that the recipient would otherwise not alter. Many types of payments or favors can constitute bribes: tips, gifts, favors, discount, waived fees, free foods, free advertising, free trips, free tickets, donations, campaign contribution, sponsorship/backing, higher paying job, stock options, secret commission, or promotions. The key to identifying bribery is that it is intended to alter the recipients behavior.

The simplest form of bribery: a parent who tells a child that if he behaves while at the grocery store, he will get ice cream or a toy. This is a common and mostly harmless form of bribery, but does it set the tone for expecting a future favor in exchange for good behavior? In business, bribery can be very subtle. Consider the following example:

You are the purchasing manager for a manufacturing company. There are several suppliers from whom you can purchase component parts used in the production of your finished product. One of the supplier representatives comes by every Monday morning with biscuits for you and your staff. He calls you on occasion and offers you tickets to sold-out sporting events and sends a lavish gift basket every Christmas. Is this just good business on his part, building a personal relationship with you and your staff, or is there an expectation that, in exchange for his generosity, you will select his company's product over the competition— even though he's not the most cost-effective choice? Are you taking a bribe when you accept the football tickets? These small "tokens of appreciation" can be construed as bribes, and as a result, many companies prohibit their employees from accepting gifts from suppliers and vendors.

One of the challenges in determining whether or not someone has taken a bribe or simply accepted a gift is that the social and cultural norms governing bribery and gift giving can differ from place to place. Certain monetary transactions are acceptable and appropriate in some cultures but not in others. For example, political campaign contributions in the form of cash are considered criminal acts of bribery in some countries, but in the United States, as long as they adhere to election law, they're legal. Tipping is considered bribery in some societies, but in others the two concepts are very different.

A **kickback** is a form of negotiated bribery in which a commission is paid to the bribe-taker in exchange for services rendered. Generally speaking, money, goods, or services handed over are negotiated ahead of time. The kickback varies from other kinds of bribes in that there is implied collusion between agents of the two parties, rather than one party extorting the bribe from the other. The purpose of the kickback is usually to encourage the other party to cooperate in the illegal scheme.

Armando granillo

Consider the following case of a former Fannie Mae employee, Armando Granillo:

Before dawn one hazy March day in L.A., Granillo pulled his SUV into a Starbucks near MacArthur Park, where he planned to pick up an envelope full of cash from an Arizona real-estate broker, federal

investigators say.

Granillo, a foreclosure specialist at mortgage giant Fannie Mae, expected to drive off with $11,200—an illegal kickback for steering foreclosure listings to brokers, authorities allege in court records. Granillo would leave in handcuffs. And investigators are looking into assertions by Granillo and another former Fannie Mae foreclosure specialist that such kickbacks were “a natural part of business” at the government-sponsored housing finance company, as Granillo allegedly told the broker in a wiretapped conversation.

Regulators keep a close watch for kickback deals as the housing market heats up and new regulations take hold following the mortgage meltdown, which exposed widespread corruption in the housing and lending markets. Consumer Financial Protection Bureau Director Richard Cordray said his agency has moved to shut down kickback operations not only because they’re illegal but also because they reduce competition and increase costs to the public.

Conflict of Interest

Conflict of interest (COI) is an ethical challenge that occurs when an individual or organization is involved in multiple interests that are at odds with one another. COI is especially problematic in situations involving someone in a position of trust—e.g., a doctor or lawyer—who has competing professional or personal interests. These competing interests make it hard to act on behalf of one interest without compromising the integrity of the other. The following are some of the most common forms of conflict of interest:

- **Self-dealing**, in which an official who controls an organization causes it to enter into a transaction with the official, or with another organization that benefits the official, i.e., the official is on both sides of the “deal”.
- **Outside employment**, in which the interests of one job contradict another.
- **Family interests**, in which a spouse, child, or other close relative is employed (or applies for employment) or where goods or services are purchased from such a relative or a firm controlled by a relative. For this reason, many employment applications ask if one is related to a current employee. In this event, the relative may be recused from any hiring decisions. Abuse of this type of conflict of interest is called nepotism.
- **Gifts from friends** who also do business with the person receiving the gifts (may include non-tangible things of value such as transportation and lodging).

Example 6.4.1

Margaret Hatch is a member of the Pasadena County Zoning Board that is responsible for approving plans for commercial development in the county. The zoning board is currently in the preliminary stages of reviewing plans proposing a new shopping center on the north end of the county. The plans include several fast-food restaurants, a multiplex movie theater, and several national retailers that do not have a presence in the county. Everyone on the zoning board agrees that this shopping center could create a new “retail/service hub” that would attract business not just from Pasadena County but from two neighboring counties, as well.

Margaret’s family owns a considerable amount of farmland adjacent to the proposed site, and after talking with the developer, it becomes clear that future expansion of the shopping center would require the use of her land plus two parcels she does not own. Margaret talks to her husband, Phil, who is a real-estate broker, about the proposed development and what she believes it will mean to the future of the area. Several days later, Phil comes home and tells Margaret that he has spoken to the

owners of the other two parcels and they are willing to sell their land for below current market value if the sale can be closed quickly. Margaret and Phil agree that they will use the equity line on their home to purchase the two parcels as soon as possible.

How would the Pasadena County Zoning Board view Margaret's actions? What will be the consequences of their purchase of the additional parcels of land? What happens when the owners learn that the uncultivated farmland they sold to Margaret and Phil has been rezoned to commercial and resold to a developer? What would the State Board of Realtors say about Phil's actions? Is this just "being in the right place at the right time," or is it something much less ethical?

A code of ethics can help to minimize problems with conflicts of interest because it spells out the extent to which such conflicts are to be avoided and what the parties should do if they do arise (disclosure, etc.). Such codes also help raise awareness, making it less likely that professionals can legitimately claim that they were unaware that their behavior was unethical. In addition, the threat of disciplinary action (for example, a lawyer being disbarred) helps to minimize unacceptable conflicts or improper acts when a conflict is unavoidable.

Whistleblowing

A **whistleblower** is a person who exposes any kind of information or activity that is deemed illegal, unethical, or not correct within an organization that is either private or public. Many whistleblowers have stated that they were motivated to take action to put an end to unethical practices after witnessing injustices in their businesses or organizations. In addition to ethics, social and organizational pressure are a motivating forces. A 2012 study found that individuals are more likely to blow the whistle when several others know about the wrongdoing, because they would otherwise fear consequences for keeping silent.

The motivation for whistleblowing isn't always virtuous, and the outcome isn't always positive either. There are cases involving employees who blew the whistle as an act of revenge against their employer or supervisor, for instance. While it's possible for the whistleblower to be viewed as a "hero" for her courage and truth telling, it's also possible to be seen as a traitor or tattletale—as just one of the many disgruntled employees who are simply trying to get even for a perceived but imaginary injustice. One of the barriers to whistleblowing is the belief—widespread in the professional world—that individuals are bound to secrecy within their work sector. Accordingly, whistleblowing becomes a moral choice that pits the employee's loyalty to an employer against the employee's responsibility to serve the public interest. As a result, in the United States whistleblower protection laws and regulations have been enacted to guarantee freedom of speech for workers and contractors in certain situations. Whistleblowers have the right to file complaints that they believe give reasonable evidence of a violation of a law, rule, or regulation; gross mismanagement; gross waste of funds; an abuse of authority; or a substantial and specific danger to public health or safety.

Some of the more notable whistleblowers in recent years include the following:[1]

- 2010: **Cheryl D. Eckard**, a GlaxoSmithKline (GSK) whistleblower, exposed contamination problems at GSK's pharmaceutical manufacturing operations, which led to a $750 million settlement with the U.S. government related to civil and criminal charges that the firm manufactured and sold adulterated pharmaceutical products. Eckard was awarded $96 million in 2010, at that time a record for an individual whistleblower.
- 2012: **Dr. Eric Ben-Artzi** publicly came forward with his evidence of multi-billion-dollar securities violations at Deutsche Bank. As an employee, he discovered and internally reported serious violations stemming from the bank's failure to report the value of its credit-derivatives portfolio accurately.
- 2013: **Jim Schrier**, a veteran USDA meat inspector, reported clear humane-handling violations involving market hogs at a Tyson Foods slaughter facility. After raising concerns to his supervisor, he was sent to work at a facility 120 miles away. His wife started a Change.org petition that has gathered more than 180,000 signatures asking the USDA to move her husband back to his original post near their home.
- 2013: USDA poultry inspector **Sherry Medina** has collected more than 70,000 signatures in a Change.org petition asking Tyson Foods to stop its excessive use of hazardous chemicals in poultry processing. Medina exposed the serious health issues

that she and other inspectors have experienced while working at a Tyson plant in Albertville, Alabama.
- 2013: **Edward Snowden** is a former Booz Allen Hamilton federal contractor employee who disclosed information regarding the NSA's blanket surveillance of U.S. citizens through a secretive data-mining program that collects the phone records, e-mail exchanges, and Internet histories of hundreds of millions of people around the globe.

Whistleblowing is often the subject of heated debate and controversy. The Edward Snowden case is a good example. Widely discussed in the media and academia, the verdict on Snowden's actions is still out: did he behave heroically or traitorously? Is it right to report the shady or suspect practices of the government? How does one choose between loyalty to one's employer and loyalty to those affected by the employer's (or government's) wrongdoing? These are the ethical challenges one faces.

Examples of Unethical Business Behavior

In business, sometimes ethics comes down to deciding whether or not to tell the truth. Admitting an error, disclosing material facts, or sending a customer to a competitor are all decisions that business people make based on issues of honesty and integrity. Because honesty and integrity are often used in the same breath, many people believe that they are one and the same. However, they are decidedly different, and each is important in its own way. As Professor Stephen L. Carter of Yale Law School points out in his book *Integrity*, "one cannot have integrity without being honest, but one can be honest and yet lack integrity."

Integrity means adherence to principles. It's a three-step process: choosing the right course of conduct; acting consistently with the choice—even when it's inconvenient or unprofitable to do so; openly declaring where one stands. Accordingly, integrity is equated with moral reflection, steadfastness to commitments, and trustworthiness.

The major difference between honesty and integrity is that one may be entirely honest without engaging in the thought and reflection that integrity demands. The honest person may truthfully tell what he or she believes without the advance determination of whether it's right or wrong. Sometimes the difference is subtle. Take the following example:

Being himself a graduate of an elite business school, a manager gives the more challenging assignments to staff with the same background. He does this, he believes, because they will do the job best and for the benefit of others who did not attend similar institutions. He doesn't want them to fail. He believes his actions show integrity because he is acting according to his beliefs, but he fails the integrity test. The question is not whether his actions are consistent with what he most deeply believes but whether he has done the hard work of ascertaining whether what he believes is *right* and *true*.[2].

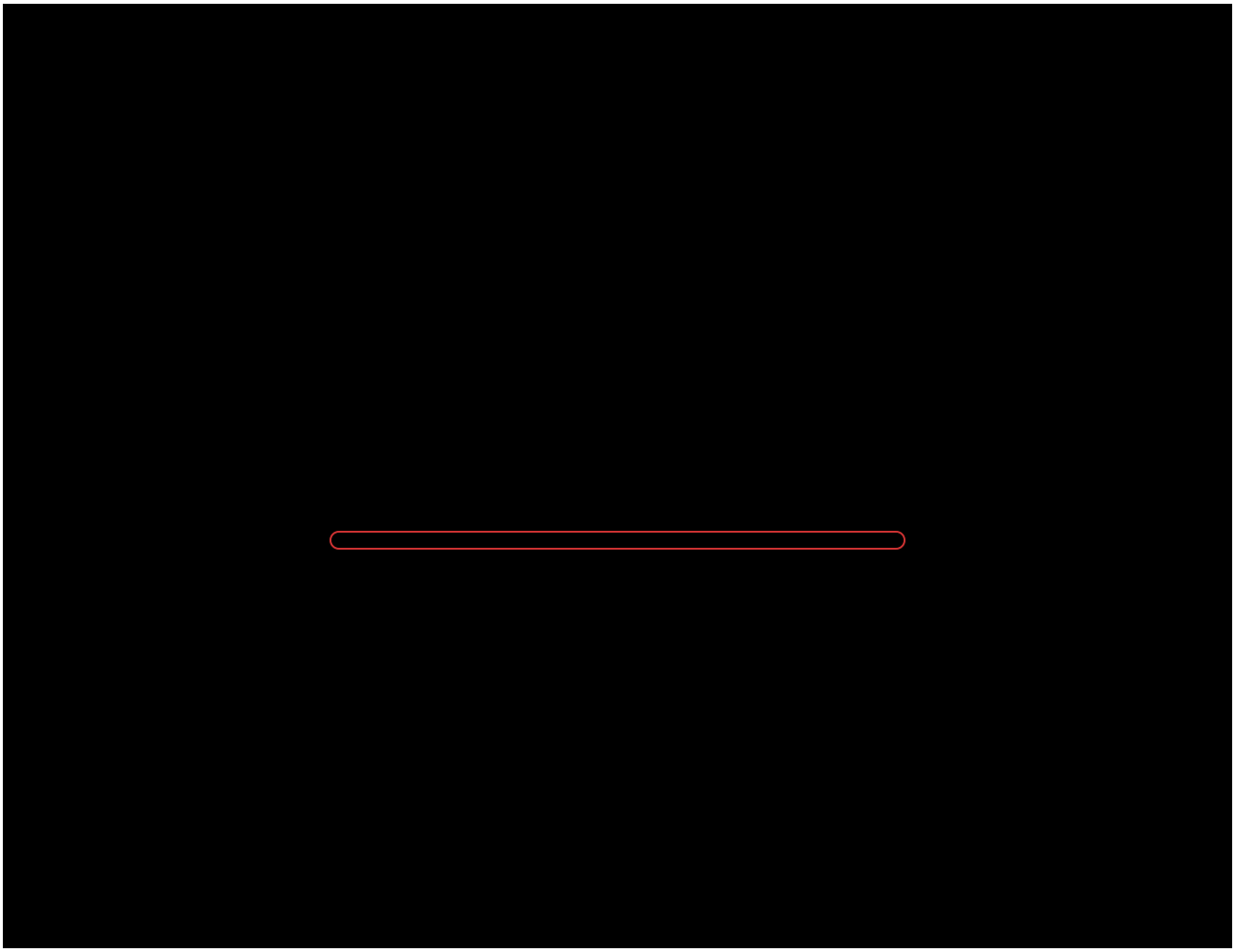
Companies that value honesty and integrity can expect to see those values permeate their company culture. In such a climate, coworkers trust one another, employees view management with less suspicion, and customers spread the word about the company's ethical behavior. Honest companies also don't have to worry about getting into trouble with the IRS or the media on account of ethical wrongdoing. Even though a company may have to give up short-term gains in order to maintain an atmosphere of honesty and integrity, in the long run it will come out ahead.

learn more

Read how seven business leaders made decisions to act with honesty and integrity.

Try It

Play the simulation below multiple times to see how different choices influence the outcome. All simulations allow unlimited attempts so that you can gain experience applying the concepts.



Case Study: Microsoft's Gift to Bloggers

Introduction

Gift giving in business is both commonplace and controversial at the same time. Business gifts are usually seen as an advertising, sales-promotion, and marketing-communication medium.[3] Such gifting is usually practiced for the following reasons:

1. In appreciation for past client relationships, placing a new order, referrals to other clients, etc.
2. In the hopes of creating a positive first impression that might help to establish an initial business relationship
3. As a quid pro quo—returning a favor or expecting a favor in return for something[4]

Making good decisions about when business gifts are appropriate is extremely complex in the United States. In a global business environment, it becomes one of the most challenging ethical issues, since the cultural norms in other countries can be at odds with standard ethical practices in the United States. For this reason, gifts and bribes warrant a deeper discussion.

Let's examine one of Microsoft's promotions that included a gift.

Microsoft's Gift to Bloggers

When Microsoft introduced its Vista operating system, the launch included a noteworthy promotion. During the 2006 Christmas season, the company sent out ninety Acer Ferrari laptops, loaded with Windows Vista Operating system, to approximately ninety influential bloggers. Different bloggers received different machines, but the lowest model was worth around two thousand dollars. Michael Arrington, editor of TechCrunch, shared the message that accompanied his gift:

> *"This would be a review machine, so I'd love to hear your opinion on the machine and OS. Full disclosure, while I hope you will blog about your experience with the PC, you don't have to. Also, you are welcome to send the machine back to us after you are done playing with it, or you can give it away to your community, or you can hold on to it for as long as you'd like. Just let me know what you plan to do with it when the time comes. And if you run into any problems let me know. A few of the drivers aren't quite final, but are very close.[5]"*

Clearly, Microsoft was hoping to encourage reviews of Vista and wanted to make sure that the bloggers experienced Vista on a high-end machine that would optimize performance. Did they also hope to influence the bloggers' opinions of the company along the way?

Sending the gift to bloggers was a risky marketing tactic even without the ethical question. Culturally, bloggers are a highly influential group of people with strong opinions, which they share openly to a wide audience. Many of the recipients reacted to the gift by sharing the news of the promotion and their opinions about it. A broad range of ethical issues emerged from the discussions in the blogosphere. Below are several excerpts.

The Gifts Diminish Trust in the Reviewers

> *"Now that I know these guys (any gals?) have access to a tailored laptop, preloaded, etc., I know their wisdom is no longer that of The Crowd—I suspect it is going to be tainted (even if not the case), so I have already discounted them. And, since I don't know who has and has not had the gift, I will distrust them all on this subject![6]"*

The Laptops Provide a Review Experience That Will Not Match Users' Experiences

> *"If you've ever tried to add a new Microsoft OS to an existing computer, you know you can't do that without totally f****** up your computer. The only way to switch to a new Microsoft OS is to start with a new computer. And, of course, to wait a year or two while they get the kinks out. Microsoft wouldn't chance having dozens of bloggers writing about how VISTA screwed up their computers, so they installed the system on brand-new computers. They gave the computers as gifts instead of lending them to the bloggers for review, which is the norm when dealing with traditional journalists."*

The Bloggers Should Disclose the Gift in Their Reviews

> *"Microsoft's approach raises some problematic issues . . . How many bloggers have received a notebook but have not declared it on their blog? Quite a few, I suggest, which highlights the fundamental problem with blogging, which is that bloggers are not trained journalists and not necessarily in tune with the ethical problems that gifts entail . . .*
>
> *Finally, sending bribes to bloggers is not a good look for Microsoft, and this is exactly how this initiative will be perceived. Even as they try to defend themselves, Microsoft's PR gurus show that they do not understand the blogosphere.[7]"*

Another blogger shared the disclosure concern while supporting the promotion:

> *"That is a GREAT idea. After all, how can anyone have a decent conversation about Windows Vista without having put a bunch of time on one of the machines? Now, regarding blogger ethics. Did you disclose? If you did, you have ethics. If you didn't, you don't. It's that black-and-white with me.[8]"*

While there was not a clear consensus on the ethics of this promotion, the debate drowned out whatever little positive opinion Windows Vista had generated in the blogs. The Microsoft case stands as a good example of a business gift program gone wrong. The company not only wasted the money spent on the gifts (none of the bloggers reported to have returned the laptops) but suffered weeks of bad press—and soured the commercial launch of the product.

Three Dimensions of Evaluating Gifts

The Microsoft example provides a three-dimensional framework by which to evaluate whether a gift crosses the line into bribery. (Remember that a bribe is something given to induce someone to alter their behavior—in this case, to write a favorable product review.) The framework helps establish guidelines for keeping business gifting aboveboard.

Content

The chief problem with Microsoft's gift was the content. Content refers to the nature of the gift itself (a shiny, new, top-of-the-line laptop) and the price ($2,000 or more). The company claimed that such a high-end machine was necessary to showcase the full capability of the Windows Vista operating system. And, they asserted, since the bloggers were given the option of returning the laptops (or giving them away), the issue of bribery didn't come into play and the onus of acting ethically fell to the recipients.

Nonetheless, Microsoft's actions represented a departure from standard industry practice of sending preview disks of software to opinion-makers. While it might be acceptable to give out $2,000 gifts in other industries (like sending out expensive fashion clothing to movies stars), and one can dicker about whether $2,000 is or isn't too extravagant, the point is that Microsoft broke with the conventions of its own industry.

The key lesson is that *what* is being given defines the nature of gifting, and extreme care must be taken to determine whether that gift is appropriate. While the market price of a gift item can be used as a benchmark, the type of gift is as important as its price. If Microsoft had given out $2,000 worth of software, it wouldn't have been so controversial. Another point, which Microsoft surely knew, is that items sent around Christmastime are more apt to be perceived as gifts.

Context

The other objection to the Microsoft gifts was the company's motives for giving them. People argued that Microsoft sent the expensive laptops to bloggers as a quid pro quo. Though the accompanying email said "you don't have to write about Vista," that was mainly a legal disclaimer meant to protect Microsoft against formal bribery charges (U.S. corruption law prohibits corporate gifts designed to induce action by the recipient). The company may have kept itself out of legal hot water, but it remained vulnerable to the charge that it tried to exert psychological pressure on the bloggers to write about their "pleasurable" experiences with Vista.

The other argument was that laptops were given to the bloggers so that they would lack the proper testing environment of mainstream tech journalists. The bloggers were set up to write good things about Vista by seeing it function in a brand-new machine, tuned and tested for this purpose by Microsoft engineers. The experience of actual users—who might be influenced by these bloggers' opinions—would be different, since they would have to install the software on older machines with no help from Microsoft. Critics argued that the company's promotion was intended to create a false opinion of the market.

While most businesses define what is a bribe and what isn't in terms of the *content* of the gift, in most countries the matter is decided on the basis of *context*. So, regardless of the size, type, and value of the gift, if it can be established that the gift was given with the intent to induce an action, it will be regarded as a bribe. The lesson here is that it isn't enough for businesses to set clear value/type limits on corporate gifts; it's also necessary to scrutinize the motives behind the gift giving, think carefully about how the gift will be received, and stop short of anything that induces the recipient to crosses the line of ethical behavior.

Culture

Other critics held that Microsoft's blunder was not caused by the content or context of the gifts but that the company fundamentally misunderstood the culture of blogging. This view came primarily from marketing practitioners, who pointed out that giving the laptops to elite bloggers violated the egalitarian and sponsorship-free nature of social media. It's a culture whose members loathe any kind of commercial taint to their independence and are highly sensitive to charges of "selling out."

Thus, culture is clearly the third very important aspect of gift giving. It's crucial to establish clear boundaries and protocols so that gifts are truly received as gifts—not as attempts to influence. To do that means factoring in the recipient's mindset and culture, since what may be perceived as a gift in one group may seem like a bribe in another. The "cultural" dimension is easily understood in personal gift giving (a toy truck might be an excellent present for your six-year-old nephew, but it wouldn't be appropriate for your boss or grandparent). Yet, somehow the idea of discretionary gift giving hasn't gained much ground in business. However, understanding the cultural preferences of the receiver is obviously an important issue in international business.

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6.5: Corporate Social Responsibility

Learning Objectives

- Describe the impact of CSR on direct and indirect stakeholders
- Give examples of corporate social responsibility
- Discuss controversies surrounding CSR

Corporate Social Responsibility

History of Corporate Social Responsibility

American President Calvin Coolidge said in the 1920s that "the chief business of the American people is business." It was a popular observation in a time of economic prosperity, when issues such as energy security and climate change were practically nonexistent.

Almost a century later, things are very different. Now, more than ever, private enterprise is being called upon to exercise social responsibility, especially when it comes to the environment. This trend reflects the view that companies ought to do more than simply meet the letter of the law and the bare minimum of ethical business behavior. Today we discuss the idea of "corporate social responsibility."

President Coolidge, like many American presidents before and since, kept government out of the affairs of business as much as possible. But starting in the 1960s and 1970s, the environmental impact of an ever-expanding economy was generating more and more protest from citizens. The result was a wave of legislation designed to reduce the pollution produced by business activity. Those laws had positive effects and are now vital parts of the American regulatory framework. But despite these regulations, controlling pollution continues to be a challenge. And now there are even larger problems on the horizon.

Even though businesses today are more efficient and use fewer resources to make goods—thanks to technological advances—many ecosystems continue to suffer. This is because the scale of economic activity grows every year, despite environmental improvements by individual enterprises.

Starting a few years ago, many citizens in the U.S. and around the world began calls for more action from private enterprise on these social issues—beyond compliance with regulations and traditional charity-related work. The result was a new movement known as corporate social responsibility, or CSR.

CSR Defined

Corporate social responsibility (CSR) can be simply and broadly defined as the ethical role of the corporation in society. The aim of CSR is to increase long-term profits and shareholder trust through positive public relations and high ethical standards to reduce business and legal risk by taking responsibility for corporate actions. It isn't enough for companies to generate a profit and merely meet the letter of the law in their business operations. Today, many U.S. citizens expect them to generate a profit *and* conduct themselves in an ethical and socially responsible manner.

CSR strategies encourage the company to make a positive impact on the environment and stakeholders—that is, all of the parties who have a stake in the performance and output of the corporation. Stakeholders include the company's employees, unions, investors, suppliers, consumers, local and national governments, and communities that may be affected by corporate activities such as construction, manufacturing, and pollution. For some companies, CSR means manufacturing their products in a way that doesn't harm the environment and protects the consumer from potentially hazardous materials. One such company that has staked it reputation on ethical manufacturing is LUSH Cosmetics.

Demands for Corporate Social Responsibility

Some of the drivers pushing businesses toward CSR include the following:

- **Increased Pressure from Consumers**. Consumers are demanding more from the businesses that get their hard-earned money. Businesses that are perceived as valuing more than the "bottom line" are gaining favor with the buying public. Consumers—especially those in North America—are likely to vote with their wallets against companies whose social and environmental performance is poor. Forty-two percent of North American consumers reported having punished socially irresponsible companies by not buying their products.[1] For example, Starbucks has faced the animosity of anti-globalization rioters. It has been accused of mistreating its staff, avoiding corporate tax, and even wasting water. As the following video shows, the coffee company has been forced to react to increasing consumer pressure.

- **Pressure from Shareholders and Investors.** In the USA, where 61 percent of people own shares, more than a quarter said they had bought or sold shares on the basis of a company's social performance. As the table, below, shows, a similar picture emerged in Canada, Japan, Britain, and Italy.[2]

Country	%
Italy	33
USA	28
Canada	26
Japan	22
Britain	21
France	18
Germany	18

- **Supply-Chain Pressure**. As consumers pay closer attention to the social responsibility of retailers and service providers, visibility into their supply chains has also become a priority. For example, Apple has come under scrutiny and criticism for the poor working conditions and environmental hazards taking place at assembly facilities in China. Even though these facilities are outside of the U.S. and are separate corporate entities, Apple has spent considerable corporate resources defending its reliance on such suppliers. Other companies such as the Swedish international retailer of furniture and household goods are taking a proactive approach to CSR both internally and within the supply chain. A visit to the IKEA Web site allows consumers and interested parties to view the company's sustainability reports and their policy on "People and Planet."

Regardless of where the pressure originates, companies are finding that ignoring their social and environmental responsibility and impact is ultimately bad for business.

Case Study: Social Entrepreneurship at Tom's Shoes

While there is no universally accepted definition of *social entrepreneur*, the term is typically applied to an individual who uses market-based ideas and practices to create "social value," the enhanced well-being of individuals, communities, and the environment. Unlike ordinary business entrepreneurs who base their decisions solely on financial returns, social entrepreneurs incorporate the objective of creating social value into their founding business models. Social entrepreneurship has become exceedingly popular in recent years and a number of prestigious business schools have created specific academic programs in the field. It is often said that social entrepreneurs are changing the world. They are lauded for their ability to effect far-reaching social change through innovative solutions that disrupt existing patterns of production, distribution, and consumption. Prominent social entrepreneurs are celebrated on magazine covers, praised at the World Economic Forum in Davos, and awarded millions of dollars

in seed money from “angel” investors, and applauded as “harbingers of new ways of doing business.” Social entrepreneurs are thus often hailed as heroes—but are they actually effecting positive social change?

Undeniably, social entrepreneurship can arouse a striking level of enthusiasm among consumers. Blake Mycoskie, social entrepreneur and founder of TOMS Shoes, tells the story of a young woman who accosted him in an airport, pointing at her pair of TOMS while yelling, “This is the most amazing company in the world!” Founded in 2006, TOMS Shoes immediately attracted a devoted following with its innovative use of the so-called One for One business model, in which each purchase of a pair of shoes by a consumer triggers the gift of a free pair of shoes to an impoverished child in a developing country. The following video explains how it works:

sociated with social entrepreneurship is perhaps emblematic of increased global social awareness, which is ased charitable giving worldwide. A 2012 study showed that 83 percent of Americans wish brands would support causes; 41 percent have bought a product because it was associated with a cause (a figure that has doubled since 1993); 94 percent said that, given the same price and quality, they were likely to switch brands to one that represented a cause; and more than 90 percent think companies should consider giving in the communities in which they do business.

Despite the eager reception from consumers, critics of social entrepreneurship have raised concerns about the creation of social value in a for-profit context. Thus, TOMS is sometimes mistaken for a charity because it donates shoes to children in developing countries, yet it is also in business to sell shoes. The company earns an estimated $300 million a year and has made Mr. Mycoskie a wealthy man. While companies are starting to look more like charities, nonprofits are also increasingly relying on business principles to survive an uncertain economy in which donors expect to see tangible results from their charitable contributions.

Our understanding of social entrepreneurship is complicated by the absence of any consensus on ways to measure social outcomes. As a result, there is little concrete statistical data available on the impact of social entrepreneurship. Indeed, there is not much agreement on a precise definition of social entrepreneurship, so it becomes difficult to say to what extent any given company is an example of social entrepreneurship. TOMS’ Chief Giving Officer, Sebastian Fries, recently told the New York Times that the company is “not in the business of poverty alleviation.” Does this mean that increased social value is merely a happy by-product of the business of selling shoes? If so, what makes Blake Mycoskie a social entrepreneur?

Some critics go so far as to suggest that social entrepreneurs are merely using public relations tactics to engage in social or environmental greenwashing—taking advantage of consumers’ desire to do good. In some cases, it has been argued, social entrepreneurs can even do more harm than good. Lacking a full understanding of the socioeconomic and cultural dynamic of the developing countries in which they intervene, social enterprises can undermine fragile local markets and foster dependence on foreign assistance. But in the end, the individual impact of social entrepreneurial ventures may outweigh some of these concerns.

In the following video, employees of Tom’s Shoes share some of the thank-you letters the company has received.

Examples of Corporate Social Responsibility

Not all companies approach CSR in the same way. Their approach depends upon their resources, available assets, and corporate culture. In addition, some companies perceive more benefit from one type of CSR than another. The personal beliefs and priorities of senior management/ownership can also influence the company's approach to social responsibility. Below are some different approaches to CSR.

Corporate Philanthropy

Corporate philanthropy refers to a corporation's gifts to charitable organizations. There is an implication that the corporation's donations have no strings attached, which is probably quite rare. At a minimum, most corporations expect that their donations will be publicly attributed to the corporation, thus generating positive public relations. When corporations make large cash gifts to universities or museums, they are usually rewarded with a plaque or with a building or library named after the donor. Such attributions burnish the corporation's public image, and in such cases we are not dealing with true corporate philanthropy, strictly speaking, but something more in the nature of marketing or public relations.

Cause-Related Marketing

Cause-related marketing (CRM) refers to a corporation's associating the sales of its products to a program of donations or support for a charitable or civic organization. An example is provided by the famous Red campaign, in which corporations such as Nike and Gap pledged to contribute profits from the sale of certain red-colored products to a program for African development and alleviation of AIDS-related social problems. The basic idea of cause-related marketing is that the corporation markets its brand at the same time that it promotes awareness of the given social problem or civic organization that addresses the social problem. Another well-known example is the pink ribbon symbol that promotes breast-cancer awareness and is used prominently in the marketing of special lines of products by many corporations, such as Estée Lauder, Avon, New Balance, and Self Magazine. In addition to marketing products with the pink-ribbon symbol, Estée Lauder has made support for breast cancer awareness one of the defining features of its corporate philanthropy. Thus, Estée Lauder also frequently refers to such charitable contributions, currently on the order of $150 million, in its corporate communications and public relations documents.

Sustainability

Sustainability has become such an important concept that it is frequently used interchangeably with CSR. Indeed, for some companies it seems that CSR is sustainability. This is perhaps not surprising, given the growing media attention on issues related to sustainability.

Sustainability is a concept derived from environmentalism; it originally referred to the ability of a society or company to continue to operate without compromising the planet's environmental condition in the future. In other words, a sustainable corporation is one that can sustain its current activities without adding to the world's environmental problems. Sustainability is therefore a very challenging goal, and many environmentalists maintain that no corporation today operates sustainably, since all use energy (leading to the gradual depletion of fossil fuels while emitting greenhouse gases) and all produce waste products like garbage and industrial chemicals. Whether or not true sustainability will be attainable anytime in the near future, the development and promotion of sustainability strategies has become virtually an obsession of most large corporations today, as their websites will attest in their inevitable reference to the corporation's sincere commitment to sustainability and responsible environmental practices. No corporation or corporate executive today will be heard to say that they do not really care about the environment. However, if we observe their actions rather than their words, we may have cause for doubt.

Social Entrepreneurship and Social Enterprise

Social entrepreneurship and social enterprise refer to the use of business organizations and techniques to attain laudable social goals. As we'll discuss further in the next reading, Blake Mycoskie decided to create TOMS Shoes largely as a reaction to his travels in Argentina, which had exposed him to terrible poverty that left many school-age children without shoes. An important part of the corporate mission of TOMS Shoes lies in its pledge to give away a free pair of shoes for every pair purchased by a customer. TOMS Shoes' model has been imitated by many others, including the popular online eyewear brand, Warby Parker.

The difference between social entrepreneurship and CSR is that, with social entrepreneurship, the positive social impact is built into the mission of the company from its founding. Other examples of social entrepreneurship include The Body Shop, Ben & Jerry's ice cream, and Newman's Own. The Body Shop was founded by noted activist Anita Roddick who insisted that all products be derived from ingredients that were natural, organic, and responsibly sourced. Her employment policies famously allowed every employee to take off one day a month from work to engage in social or community projects. Similarly, Ben & Jerry's was founded to promote the use of organic, locally-produced food. The company's founders insisted on a policy that executives earn no more than seven times the salary of factory line-workers (although this policy was eventually relaxed when it became difficult to recruit a competent CEO at those wages). Ben & Jerry's engaged in a number of high-profile political activities in which they encouraged their employees to participate, such as protesting the building of the Seabrook nuclear power plant in Vermont. Newman's Own was founded by film actor Paul Newman and his friend A. E. Hotchner with the goal of selling wholesome products and giving away 100 percent of the profits to charitable ventures. To date, Newman's Own has given away more than two hundred million dollars.

Social Marketing

Social marketing refers to the use of business marketing techniques in the pursuit of social goals. Often, governments and nonprofit organizations make use of social marketing to make their points more forcefully and effectively to a wide audience. Classic examples are the extremely powerful TV commercials warning of the dangers of unsafe driving or of failing to use seat belts. Cinematic techniques are employed to portray dramatic, arresting images of crumpled cars and bodies, children and mothers crying. The source of social marketing advertisements is usually a local government or nonprofit organization.

Social marketing is usually used to try to convince citizens to drive more safely, eat better, report child and domestic abuse, and avoid various forms of criminality and drug use. As with ordinary advertising, social marketing can seem overdone or maudlin, and some social marketing ads have been mocked or considered silly. For example, former First Lady Nancy Reagan participated in a social marketing campaign that urged young people to "Just Say No" to drugs, an approach that was ridiculed as simplistic by many. Noted radical activist Abbie Hoffman said that telling drug users to "just say no" to drugs was like telling manic-depressives to "just cheer up." Despite that, drug use in America declined over the time period that the campaign was in progress, though there is no evidence that any part of this decline was due to the campaign.

Controversies Surrounding CSR

From the beginning, CSR has been the subject of much debate. CSR's critics argue that the main responsibility of businesses is to maximize return to their shareholders. They point to the corporate legal system as the proper place for regulating businesses' conduct with society. And besides, businesses are already fulfilling a key public service by providing jobs and services that society needs.

Other critics assert that many so-called CSR activities are really just publicity stunts and corporate "greenwashing." **Greenwashing** refers to corporations that exaggerate or misstate the impact of their environmental actions or promote products as being "eco-friendly" when in fact they're not.

Supporters of CSR contend that there are significant profit-related benefits in socially responsible behavior. Companies are using their CSR activities to recruit and keep the best management talent and to establish partnerships with communities to increase company influence on legislation. And companies that make social responsibility an integrated part of their business actually are managing risk—a key part of corporate development strategy.

Despite the ongoing debate, trends indicate that CSR is gathering force and is here to stay. More and more leading companies in America and worldwide are releasing sustainability reports. Plus, new industries like clean energy provide social and economic benefits while fighting environmental problems like climate change. The result of that combination has been called one of the greatest commercial opportunities in history.

The importance and nature of CSR is the topic of ongoing debate and controversy. Consider the following:

CSR: Sincere Ethics or Hypocritical Public Relations?

- **Facts**: CSR is a rapidly growing field of study in universities and business schools, and most large corporations have adopted CSR programs.
- **The controversial aspect:** Is CSR a good thing or is it just corporate window dressing?
- **In favor of CSR**: CSR motivates corporations to address social problems, it energizes and rewards workers, it strengthens ties to the community, and it improves the image of the corporation.
- **Against CSR:** Surveys show that citizens are more concerned about corporations treating their workers well and obeying laws than about engaging in philanthropic activities, and CSR may allow corporations to distract consumers and legislators from the need to tightly regulate corporations.

Climate Change and CSR

- **Facts**: There is a scientific consensus that global warming and climate change represent an enormous threat facing mankind.
- **The controversial aspect:** Can corporate CSR really have a significant impact on climate change, or is it just a public relations vehicle for companies and a distraction from the need for stronger government action, such as through a carbon tax?
- **In favor of global warming–related CSR:** Corporations can have a major impact in the battle against global warming by reducing their large carbon footprints, by encouraging other corporations to follow suit, and by helping discover and develop alternative sources of energy.
- **Against global warming–related CSR:** Companies spend a lot of advertising money to boast about small measures against global warming, but many of these companies are in industries—such as fossil fuels or automobiles—that produce the most greenhouse gases to begin with; self-serving claims of climate-change concern are often simply greenwashing campaigns intended to distract us from the need for society to take more effective measures through taxation and regulation.

Corporate Lobbying and Governmental Influence

- **Facts**: Most large corporations spend money on lobbying and on seeking to influence legislators and regulators. In the Citizens United decision, the Supreme Court ruled that, as “corporate persons,” corporations enjoy the same freedom of speech protections as ordinary citizens and are entitled to relief from strict government control of their rights to political speech.
- **The controversial aspect:** Many citizens are outraged to find that the justice system accords multinational corporations the same rights as ordinary people on the grounds that corporations are “persons.” However, others point out that The New York Times and CNN are also corporations, and that it could have a chilling effect on freedom of speech if all corporations were legally-constrained from speaking out freely.
- **In favor of corporate lobbying:** As major employers and technological innovators, corporations benefit society. They should be free to oppose inefficient and cumbersome government regulations and taxation that can limit the benefits they provide. In this way, freedom of political speech is so important that we should be cautious about limiting it in any way.
- **Against corporate lobbying:** Corporations are not “persons” in the same sense that humans are, and therefore, they should not enjoy the same freedom of speech protection. Since corporations can become vastly wealthier than ordinary citizens, allowing them to participate in politics will enable them to bend laws and regulations to their will.

In each of the debates outlined above, there are intelligent and well-informed people on both sides of the issue. How CSR is defined and practiced differs for each enterprise. But for all those companies, the view seems to be that CSR programs are a good investment.

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1. https://www.iisd.org/business/issues/sr_csrm.aspx ↵
2. https://www.iisd.org/business/issues/sr_csrm.aspx ↵

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6.6: Putting It Together- Business Ethics and Corporate Social Responsibility

Synthesis

Throughout this module you learned about the legal and ethical challenges businesses face in today's complex environment. Decisions about doing the "right thing" are not necessarily represented by a single big decision; rather, they are often a series of many apparently small decisions that can culminate in an organization finding itself on the wrong side of its stakeholders, society, and the law. Even corporate executives who have been imprisoned for unethical conduct later admit that they knew that what they were doing was wrong, but somewhere along the line they lost sight of their own standards or honesty and integrity. Unfortunately, such behavior can have devastating consequences for the public, the environment, and the company—and it can cast a cloud on businesses that make good ethical, legal, and socially responsible choices every day. As the public demands a higher level of corporate social responsibility, companies are adjusting their strategies to respond to the external environment and conduct business in a way that promotes trust and loyalty from their customers. In addition, the government has stepped in and enacted legislation intended to set forth stronger guidelines, processes, and even punishments for unethical business practices. When you leave school and begin to look for your first job, a new job, or even take a closer look at your current employer, one of the questions you should now be prepared to ask is whether or not the ethics of the organization are aligned with your own sense of right and wrong.

Summary

Ethical and Legal Behavior

Standards of ethical and legal behavior are intertwined but are separate "codes" arising from different sources. Legality comes from legislation or case law that establishes standards of behaviors—illegal behavior may be punished by fines, imprisonment, or both. As a branch of philosophy, ethics investigates the questions "What is the best way for people to live?" and "What actions are right or wrong in particular circumstances?" In practice, ethics seeks to resolve questions of human morality, by defining concepts such as good and evil, right and wrong, virtue and vice, justice and crime.

Business Ethics

Businesses and organizations possess a set of ethical standards just like people. When we refer to "business ethics" we are referring to the culture, attitudes, or actions governing "right vs. wrong." Most organizations have a formal code of ethics that guide the decisions and actions of the company.

Ethical Challenges

Businesses and their employees, managers, and owners face a variety of ethical issues as they go about their working lives. Ethical issues include conflicts of interest, bribes, conflicts of loyalty, and issues of honesty and integrity.

Corporate Social Responsibility

Corporate social responsibility (CSR) refers to actions that businesses take or refrain from taking based on the impact of those actions on the external environment and community. Areas of CSR include environmental concerns (green business), poverty, human rights, and animal rights. Today, businesses are realizing the importance of CSR (Corporate Social Responsibility) in attracting and maintaining employees and customers. Stakeholders are demanding that businesses give back to the larger community in which they operate. Examples of stakeholder and social responsibility can be seen at companies such as Toms Shoes and Starbucks.

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CHAPTER OVERVIEW

7: Business Ownership

7.1: Why It Matters- Business Ownership
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7.1: Why It Matters- Business Ownership

Why distinguish among the forms of business ownership?

The way a business is formed as a legal entity has implications far beyond the business. Did you know that if your business fails and you can't repay your business creditors, you could lose your home, car, and most of your personal belongings? Or, if you select the wrong legal form of ownership, you could find yourself in a position of owing a large sum of money to the Internal Revenue Service? Did you realize that if your business has not been formed in a way that protects you if someone slips and falls in your store that you could be personally liable for their pain and suffering?

These are a few reasons why it's important to understand the different legal forms of business. Take a look at the following video and see what happened to a family who ran their own business as a sole proprietorship and experienced the impact of the recent recession. In the rest of this module you'll learn about the factors one should consider when choosing a form of business ownership.

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7.2: Choosing an Organizational Type

What you'll learn to do: list and explain the important factors in choosing an organizational type

The organizational type you choose for your business, sometimes called a "legal structure," can impact your taxes and income. In this section you'll learn about the key factors that business owners should consider when choosing an organizational type.

Learning Objectives

- Explain the important factors in choosing an organizational type

Selecting a Form of Business Ownership

One of the first and most important decisions a business owner makes is selecting the organizational form under which he or she will operate. The following are some common organizational types (also called "legal structures"):

- Sole proprietorship
- General partnership
- Franchise
- Limited partnerships and limited liability partnerships (LLP)
- Limited liability company (LLC)
- C corporation
- S corporation

Each form of ownership has advantages, disadvantages, risks, and rewards that can affect the business's chances for long-term success. The following are some of the important factors business owners should consider when selecting a form of ownership.

Cost of Start-up

Setting up a business can involve little more than printing some business cards, or it may entail hiring a corporate attorney to draft corporate charters, agreements, and articles of incorporation. As the forms of business ownership become more complex, the cost associated with establishing the business also increases. Every business owner must decide how long he/she wants to wait before getting the business up and running and also how much of his/her own money to invest.

Control vs. Responsibility

One of the primary reasons people give for wanting to start their own business is the desire to be independent and "be your own boss." Different legal structures provide the owner with more or less control and authority. There are trade-offs in each case, though, because with autonomy and control come responsibility. For instance, if you're the sole proprietor of a business with no employees, as a one-person show, you retain all the control, but you also have all the work and responsibility. Other forms of business (such as partnerships, for example,) may mean relinquishing some control, but, in return, the responsibility (and liability) may be spread among several principals. You'll learn more about these trade-offs later in the module.

Profits—to Share or Not to Share

Many first-time business owners look to people like Bill Gates, Oprah Winfrey, or Ben & Jerry and aspire to their level of wealth and success. How a business's profits are shared (or not shared) is determined by the legal structure. Some owners are willing to share the profits in exchange for assistance and support establishing and running the business. Other business owners make the conscious decision to limit the scope and nature of the business to avoid having to bring in others, thereby retaining all of the income themselves.

Taxation

When planning to start a new business, many people instinctively seek the advice of an attorney as the first step in the process. However, legal advice is not actually what's needed initially. Instead, no matter how large or small your business is going to be, it's much more important to first get the advice of a seasoned tax professional, such as a CPA. The reason for this is that each form of business ownership is treated differently by the IRS and by state and local taxing authorities. Depending on the legal structure of the business, the owner may be taxed at a lower rate than someone working for a large company, or the owner might see his or her business income taxed twice, sometimes with additional speciality taxes imposed by governmental agencies. The time for a

business owner to decide how heavy a tax burden he/she is willing to bear is at the start of the business, not on April 15 when taxes are due.

Entrepreneurial Ability

At some point you've probably known someone with a particular knack for something (like fixing cars or baking bread) and said, "You should start your own business!" But if you are a talented cake decorator, say, does that necessarily mean you have the requisite knowledge, skills, and abilities to open and run a successful commercial or retail bakery? It's often easier said than done. Many businesses fail despite the owner's enthusiasm and/or talent, because the owner lacks the deep knowledge and expertise needed to transform an interest or hobby into a commercial enterprise. Performing an honest and accurate appraisal of one's skills, background, and entrepreneurial abilities *before* launching a business can prevent disappointment and failure later on.

Risk Tolerance

Everyone's tolerance for risk is different. Some people enjoy the rush of skydiving and rollercoasters, while others prefer to stick to the carousel or keep their feet on the ground. In business, one's degree of risk tolerance should be compatible with the form of ownership being considered. For example, a forty-five-year old entrepreneur with dependents might seek to protect her accumulated assets (real estate, savings, retirement, etc.) and therefore select a legal structure that carries less personal financial risk. Every prospective business owner must gauge what he or she is willing to risk losing and choose a form of business accordingly.

Financing

Few business owners start a business with lottery winnings or many years' worth of savings. Many seek funding from a bank, venture capitalist, private investor, or credit union in order to get their businesses off the ground. Lenders may be one of the greatest influences on the choice of business ownership—even more decisive than the owner's preference or ambition. Since there is risk inherent in any business venture, especially start-ups, lenders often require the business to be structured in a way that best assures the repayment of funds (whether the business makes it or not). Even businesses that have been established for a long time may be forced to change their legal structure when seeking funding to expand their operations. If an owner anticipates needing funding at any point during the life of the business, selecting a form of ownership that aligns with lender requirements from the start may be a wise decision.

Continuity and Transferability

Finally, business owners need to consider if they want their business to outlive them (or carry on after they leave). If an owner is looking to start a business that can be passed on to his or her children or other family members, then the legal structure of the business is extremely important. Certain organizational types "die" with the owner, so it's crucial for the owner to decide how and whether a business will persist and/or be sold to new ownership.

These are just some of the considerations business owners must weigh when selecting a form of business ownership. Many of these issues require owners to look far into the future of their business and imagine all of the "what if's" associated with being self-employed. Although it is possible to change legal structure once the business is established, the more complex the business operations are the more complex the change will be. In some cases, the complexity of the situation can prevent the owner from making the change that's desired. Considering as many of these factors as possible from the outset can save countless hours and great expense down the road.

In the coming sections we will explore the possible legal structures a business owner can choose and look at the advantages and disadvantages of each. We will begin with the simplest of all organizational types: the sole proprietorshi

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7.3: Sole Proprietorships

What you'll learn to do: discuss the advantages and disadvantages of sole proprietorships

In this section we'll discuss the pros and cons of sole proprietorships.

Learning Objectives

- Discuss the advantages and disadvantages of sole proprietorship

Sole Proprietorships

A sole proprietorship is the simplest and most common legal structure someone can choose. It's an unincorporated business owned and run by one individual in which there is no distinction between the business and the owner. If you own a sole proprietorship, you are entitled to all profits and are responsible for all your business's debts, losses, and liabilities.

Forming a Sole Proprietorship

You don't have to take any formal action to form a sole proprietorship. As long as you are the only owner, this status automatically arises from your business activities. In fact, you may already own one without knowing it. If you are a freelance writer, for example, you are a sole proprietor.

As is the case when you own any kind of business, you may need to obtain the necessary licenses and permits. For example, certain businesses, like ones that sell alcohol or firearms, require a federal license or permit. Some states have requirements for other specific businesses. Additionally, some professions such as Certified Public Accountants (CPAs) may have licensing or certification requirements that must be met before you can promote yourself as engaging in that business or trade. Regulations vary by industry, state, and locality.

If you choose to operate under a name different from your own, you will most likely have to file a fictitious name (also known as an assumed name, trade name, or DBA name—short for "doing business as"). This document is usually filed in the records of the county or city in which you do business. This requirement exists because if customers want to contact (or sue) the person running the business, the law requires the owner to inform the public of the person behind the "business." You must choose an original name; it cannot already be claimed by another business. In order to check the availability of a business name, business owners may search the database maintained by the State Secretary of State.

Sole Proprietor Taxes

Because you and your business are one and the same, the business itself is not taxed separately—the sole proprietorship income is your income. It's your responsibility to withhold and pay all income taxes, including self-employment and estimated taxes.

Advantages of a Sole Proprietorship

- **Easy and inexpensive to form.** A sole proprietorship is the simplest and least expensive legal structure to establish. Costs are minimal, with legal costs limited to obtaining the necessary license or permits.
- **Complete control**. Because you are the sole owner of the business, you have complete control over all decisions. You aren't required to consult with anyone else when you need to make decisions or want to make changes.
- **Easy tax preparation.** Your business is not taxed separately, so it's easy to fulfill the tax reporting requirements for a sole proprietorship. The tax rates are also the lowest of the legal structures. However, sole proprietors are encouraged to consult a tax adviser regarding taxes that they may have to pay once an employer is no longer withholding and remitting tax payments on their behalf.

Disadvantages of a Sole Proprietorship

- **Unlimited personal liability**. Because there is no legal separation between you and your business, you can be held personally liable for the debts and obligations of the business. This risk extends to any liabilities incurred as a result of employee actions. Individuals running a business as a sole proprietorship should carefully review their insurance policies on vehicles and equipment and verify that they have adequate liability coverage. Some businesses may require specialized forms of insurance

such as Worker's Compensation, Liability, or Errors & Omissions. Checking coverage with a reputable insurance agent will help the owner identify potential risks and the insurance available to mitigate these risks.

- **Hard to raise money**. Sole proprietors often face challenges when trying to raise money. Because you can't sell stock in the business, investors won't often invest. Banks are also reluctant to lend to a sole proprietorship because of the perceived risk and uncertainty around repayment of funds if the business fails.
- **Heavy burden.** The flip side of complete control is the burden and pressure it can bring. You alone are ultimately responsible for the successes and failures of your business.

tw's construction

Given how easy it is to establish a sole proprietorship, Tom decides that this is the form of ownership he'll choose. He doesn't need to borrow any money to start his business, and since he will be doing all the work himself, at this point he isn't worried that this type of ownership will add additional burdens or stress. He also likes the idea that he is in control of which jobs he takes and who his customers are.

He stops by his accountant's office and asks her about the taxes, because that part is still a little unclear to him. She explains that when Tom was working for Bob the Builder, federal and state income taxes were withheld from his paychecks. Bob the Builder sent those funds to the IRS and state department of revenue on Tom's behalf. Those were the taxes he got credit for when he filed his tax return at the end of the year. Bob the Builder also paid half his social security and medicare taxes for him. The company also paid into the state unemployment insurance fund in case an employee ever filed for unemployment benefits. The accountant tells Tom that now, as a sole proprietor, he'll need to plan for taxes throughout the year, not just in April—no one else will be withholding or paying taxes for him. This is depressing news, but Tom is happy to learn that he may be able to deduct many of the expenses he incurs in the course of operating his business. These include things like his work van, tools he purchases, office supplies, and possibly the small office he has set up in his home. She recommends that Tom come see her at the end of each fiscal quarter (March, June, September, and December) to make sure that he is on track with his taxes for the year. He thinks this is great advice and schedules the appointments on the spot.

After leaving the accountant's office, he goes to the courthouse and files his DBA certificate (for the name of his business) and begins operating as a sole proprietorship: TW's Construction. Lastly, he stops by his insurance agent and makes sure that he has the proper insurance on his vehicles and equipment, verifying that he has sufficient liability insurance to cover any potential claims against him.

He heads home to start calling homeowners and setting up appointments to bid on jobs. He has joined the ranks of the self-employed!

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7.4: Partnerships

What you'll learn to do: discuss the advantages and disadvantages of partnerships

In this section we'll discuss different kinds of partnerships and the pros and cons of each.

Learning Objectives

- Describe the difference between general and limited partnerships
- Discuss the advantages and disadvantages of partnerships

Partnerships

A partnership is a single business in which two or more people share ownership.

Each partner contributes to all aspects of the business, including money, property, labor, or skill. In return, each partner shares in the profits and losses of the business.

Because partnerships entail more than one person in the decision-making process, it's important to discuss a wide variety of issues up front and develop a legal partnership agreement. This agreement should document how future business decisions will be made, including how the partners will divide profits, resolve disputes, change ownership (bring in new partners or buy out current partners), and how to dissolve the partnership. Although partnership agreements are not legally required, they are strongly recommended, and it's considered extremely risky to operate without one.

Types of Partnerships

There are two general types of partnership arrangements:

- **General Partnerships** assume that profits, liability, and management duties are divided equally among partners. If you opt for an unequal distribution, the percentages assigned to each partner must be documented in the partnership agreement.
- **Limited Partnerships** (also known as a partnership with limited liability) are more complex than general partnerships. Limited partnerships allow partners to have limited liability as well as limited input with management decisions. These limits depend on the extent of each partner's investment percentage. Limited partnerships are attractive to investors of short-term projects.

Forming a Partnership

To form a partnership, you must register your business with your state, a process generally handled through your Secretary of State's office.

You'll also need to establish your business name. For partnerships, your legal name is the name given in your partnership agreement. If you choose to operate under a name different from the officially registered name, you will most likely have to file a fictitious name (also known as an assumed name, trade name, or DBA name, short for "doing business as").

Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state, and locality.

Partnership Taxes

Most businesses will need to register with the IRS, register with state and local revenue agencies, and obtain a tax ID number or permit. An additional requirement for partnerships is that they must file an "annual information return" to report the income, deductions, gains and losses from the business's operations, but the *business itself does not pay income tax*. Instead, the business "passes through" any profits or losses to its partners. Partners include their respective share of the partnership's income or loss on their personal tax returns. Like sole proprietors, partners in the partnership are responsible for several additional taxes, including income tax, self-employment tax, and estimated tax. Since partnerships can be complex, having a professional to advise the partnership and partners on tax matters is crucial.

Advantages of a Partnership

- **Easy and Inexpensive**. Partnerships are generally an inexpensive and easily formed business structure. The majority of time spent starting a partnership often focuses on developing the partnership agreement.

- **Shared Financial Commitment**. In a partnership, each partner is equally invested in the success of the business. Partnerships have the advantage of pooling resources to obtain capital. This can be beneficial in terms of securing credit or by simply doubling the seed money available.
- **Complementary Skills.** A good partnership should capitalize on the benefits of being able to utilize the strengths, resources, and expertise of each partner.
- **Partnership Incentives for Employees.** Partnerships have an employment advantage over other entities if they offer employees the opportunity to become a partner. Partnership incentives often attract highly motivated and qualified employees.

Disadvantages of a Partnership

- **Joint and Individual Liability.** Similar to sole proprietorships, partnerships retain full, shared liability among the owners. Partners are not only liable for their own actions but also for the business debts and decisions made by other partners. In addition, the personal assets of all partners can be used to satisfy the partnership's debt.
- **Disagreements Among Partners**. With multiple partners, there are bound to be disagreements. Partners should consult one another on all decisions, make compromises, and resolve disputes as amicably as possible.
- **Shared Profits.** Because partnerships are jointly owned, each partner must share the successes and profits of their business with the other partners. An unequal contribution of time, effort, or resources can cause discord among partners.

tw construction or t&t construction?

For several months Tom has been operating as a sole proprietorship and enjoying the control he maintains over his work and finances. Business is picking up and he has recently been contacted by a construction firm that wants to hire him to provide the trim carpentry for several large oceanfront homes they are building. He mentions this to his friend Todd, who seems very happy that Tom's new business venture appears to be succeeding. A month later, Todd calls and asks Tom to meet him for dinner at Sandbar's. During dinner, Todd proposes to Tom that the two of them form a general partnership: T&T Construction. Todd points out that taking on several large jobs as a sole proprietor is very risky—a partnership would mean shared risk and responsibility. He also offers to contribute some initial capital to the newly formed partnership, which would provide financial support for their day-to-day operations. Finally, Todd makes the case that, as a frame carpenter, he has skills that would complement Tom's and potentially yield additional business opportunities.

Surprised by the proposal, Tom tells his friend that he needs some time to think it over before committing. During the next few days, he calls his accountant to find out how the partnership would impact his business. He learns that he would have to share control of the business and also share the profits. That doesn't sound bad to Tom, especially if the business really grew—which it might, with the addition of Todd's skills and labor. Tom is leaning toward accepting the offer. But when he finds out that he would be held responsible not only for the debts of the business but also the actions of his partner, he sours on the idea. He knows Todd has made some business decisions and deals that were a little on the sketchy side. Under the proposed General Partnership structure, if Todd made similar kinds of decisions or deals without Tom's knowledge, Tom could still be held responsible and liable for the consequences. He's realizes he's not willing to accept that kind of risk. He decides to turn down Todd's offer and keep running his business as a sole proprietor.

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7.5: Corporations

What you'll learn to do: discuss the advantages and disadvantages of corporations

Although not the most *common* form of business ownership, corporations account for the majority of the *revenue* from business in the United States. In this section you'll learn about C and S corporations and, a newcomer to the corporate scene, the benefit corporation.

Learning Objectives

- Discuss the advantages and disadvantages of corporations
- Discuss the advantages and disadvantages of corporations

Benefit Corporations

Over the past few decades, the boundaries between the public (government), private (business), and social (nonprofit) sectors have become blurred as many pioneering organizations merge social and environmental aims with business approaches. There are many expressions of this trend, including corporate social responsibility, microfinance, venture philanthropy, sustainable businesses, social enterprise, privatization, community development, and others. There are also new forms of corporate entities. One of the most widely established is the **benefit corporation (B corp)**. In the U.S., a benefit corporation is a type of for-profit corporate entity, authorized by thirty U.S. states and the District of Columbia, that includes positive impact on society, workers, the community, and the environment—in addition to profit—as its legally defined goals. *Benefit corporations differ from traditional C corporations in purpose, accountability, and transparency, but not in taxation.*

In April 2010, Maryland became the first U.S. state to pass benefit corporation legislation.

The purpose of a benefit corporation is to create **general public benefit**, which is defined as a material positive impact on society and the environment. A benefit corporation's directors and officers operate the business with the same authority as in a traditional corporation, but they are required to consider the impact of their decisions not only on shareholders but on society and the environment, too. In a traditional corporation, shareholders judge the company's financial performance; with a benefit corporation, shareholders judge performance based on the company's social, environmental, and financial performance. Transparency provisions require benefit corporations to publish annual benefit reports of their social and environmental performance using a comprehensive, credible, independent, and transparent third-party standard.

Some well-known examples of benefit corporations are Kickstarter, Patagonia, and King Arthur Flour.

Forming a Benefit Corporation

New companies can incorporate as a benefit corporation in any state where benefit corporation legislation has been passed. (Instead of recognizing benefit corporations, Washington created social purpose corporations in 2012 with a similar focus and intent.) The process varies by state, but many states require benefit corporations to do the following:

- declare a commitment to creating general public benefit
- adopt a third-party standard
- prepare an annual benefit report
- distribute the annual benefit report to the owners and post it on the company's Web site

B Corp Certification

Businesses that want to take their social and environmental commitment even further can become a Certified B Corporation. This involves a rigorous assessment process by B Lab, which uses a survey to rate a company's environmental practices, employee treatment, activism within its community, and other factors. Businesses that surpass a certain score are certified by B Lab, which then audits them from time to time to ensure that they are living up to the movement's standards.

> *"[B Lab certification] is like a Good Housekeeping seal of approval," said David Murphy, former CEO of Better World Books, in a 2011 Business News Daily interview. "If*

> *your company is a Certified B Corporation, that really says something. You're there to serve all those stakeholders, and you're willing to prove it.*[1]"

Benefit Corporation Taxes

Benefit corporations are treated like all other corporations for tax purposes. B corps elect to be taxed either as a C or S corp.

Advantages of a Benefit Corporation

- **Protection of Mission.** Becoming a benefit corporation gives companies more options and protections if they decide to sell the business to someone else or take it public, because other factors besides price (e.g., the public benefit mission) must also be taken into account.
- **Reputation**. Incorporating as a benefit corporation allows companies to stand out as businesses that have a social conscience and aspire to a standard they consider higher than maximizing profit for shareholders. For investors and consumers who are committed to social and environmental responsibility, benefit corporations provide additional choices.
- **Creation of Value**. Because it's committed to considering other stakeholders' interests, a benefit corporation may create value via employee engagement and customer loyalty, thereby improving results for all stakeholders—including the owners/shareholders. As well, certain profit-making opportunities may not be available without an assured commitment to other stakeholders.[2]

Disadvantages of a Benefit Corporation

- **Transparency and Reporting Requirements**. Benefit corporations must provide an annual benefit report according to a third-party standard (such as B Lab) and make the report available on their company Web sites. The purpose of this is to assess the company's performance with regard to its public purpose(s).
- **Annual Fees to Retain Certified B Corp Status**. If a B corp elects to receive certification from a third party, such as B Lab, fees for "certified" B-corp status are based on annual sales, with a minimum of $500. To keep certification, the company must pay a renewal fee each year and recertify every two years.
- **Compliance and Governance Obligations**. Most states require publicly traded companies with a B corp designation to have a "benefit director" who is responsible for ensuring that the corporation meets its stated public purpose.

C and S Corporations

Corporate Rights

As a matter of interpreting the word "person" in the Fourteenth Amendment, U.S. courts have extended certain constitutional protections to corporations. Some opponents of corporate personhood seek to amend the U.S. Constitution to limit these rights to those provided by state law and state constitutions.

Corporations have unique status and rights in the American legal system. The legal provisions for such entities extend so far as to even include something called "**corporate personhood**." Corporate personhood is the legal notion that corporations, apart from their associated human beings (like owners, managers, or employees), have some, but not all, of the legal rights and responsibilities enjoyed by natural persons (physical humans). For example, corporations have the right to enter into contracts with other parties and to sue or be sued in court in the same way as natural persons or unincorporated associations of persons.

The basis for allowing corporations to assert protection under the U.S. Constitution is that they are organizations of people, and people should not be deprived of their constitutional rights when they act collectively. In this view, treating corporations as "persons" is a convenient legal fiction that allows corporations to sue and to be sued, provides a single entity for easier taxation and regulation, simplifies complex transactions that, in the case of large corporations, would otherwise involve thousands of people, and protects the individual rights of the shareholders as well as the right of association.

Since the Supreme Court's ruling in *Citizens United v. Federal Election Commission* in 2010, upholding the rights of corporations to make political expenditures under the First Amendment, there have been several calls for a U.S. Constitutional amendment to abolish corporate personhood. While the *Citizens United* majority opinion makes no reference to corporate personhood or the Fourteenth Amendment, Justice Stevens' dissent claims that the majority opinion relies on an incorrect treatment of corporations' First Amendment rights as identical to those of individuals.

The legal status, rights, and responsibilities of corporations continue to evolve in response to cultural and economic pressures. The forms they take change over time, too. As you'll see in our discussion of benefit corporations, some types of business are very recent developments indeed.

Corporation (C Corporation)

A corporation (sometimes referred to as a **C corporation**) is an independent legal entity owned by shareholders. This means that the corporation itself, not the shareholders that own it, is held legally liable for the actions and debts the business incurs. This type of general corporation is called a "C corporation" because Subchapter C of Chapter 1 of the Internal Revenue Code is where you find general tax rules affecting corporations and their shareholders.

Corporations are more complex than other business structures because they tend to have costly administrative fees and complex tax and legal requirements. Because of these issues, corporations are generally suggested for established, larger companies with multiple employees.

For businesses in that position, corporations offer the ability to sell ownership shares in the business through stock offerings. "Going public" through an initial public offering (IPO) is a major selling point in attracting investment capital and high-quality employees.

Forming a Corporation

A corporation is formed under the laws of the state in which it is registered.

Because corporations are recognized as entities separate from their owners, the process is much more complex than establishing a sole proprietorship or partnership. The corporation must be "formed" and then recognized by the state's Secretary of State office and/or State Corporation Commission. The way that corporations are "born" is through the filing of articles of incorporation with the state's Secretary of State office. Some states require corporations to establish directors and issue stock certificates to initial shareholders in the registration process. For this reason, establishing a C Corporation can be expensive. Attorneys are often engaged to draft the initial articles of incorporation, shareholders agreements, stock option agreements, and other related documentation. Filing the articles of incorporation, establishing a registered agent, and issuing stock are also tasks that attorneys perform on behalf of those forming the corporation.

As with other forms of ownership, once the corporation is formed, you must obtain business licenses and permits. Regulations vary by industry, state, and locality. If you are hiring employees, you will need to understand and follow federal and state regulations for employers.

Corporation Taxes

When you form a corporation, you create a **separate tax-paying entity**. Unlike sole proprietors and partnerships, corporations pay income tax on their profits. In some cases, corporations are taxed twice—first, when the company makes a profit, and again when dividends are paid to shareholders. These dividends appear on the shareholder's personal tax returns and are subject to taxation. It is important to note that *only income paid as dividends* is taxed twice. Income distributed as salary or other compensation is a deduction for the corporation. This means that the amount of compensation paid is deducted from the amount of corporate income that is subject to taxation.

Just like individuals, corporations are required to pay federal, state, and in some cases, local taxes. Instead of supplying a social security number for taxpayer identification, corporations must register with the IRS and state and local revenue agencies, and obtain a tax ID number.

Advantages of a Corporation

- **Limited Liability**. When it comes to taking responsibility for business debts and actions of a corporation, shareholders' personal assets are protected. Shareholders can generally only be held accountable for their investment in stock of the company.
- **Ability to Generate Capital**. Corporations have an advantage when it comes to raising capital for their business—the ability to raise funds through the sale of stock.
- **Corporate Tax Treatment**. Corporations file taxes separately from their owners. Owners of a corporation only pay taxes on corporate profits paid to them in the form of salaries, bonuses, and dividends, while any additional profits are awarded a corporate tax rate, which is usually lower than a personal income tax rate.
- **Attractive to Potential Employees.** Corporations are generally able to attract and hire high-quality and motivated employees because they offer competitive benefits and the potential for partial ownership through stock options.

Disadvantages of a Corporation

- **Time and Money.** Corporations are costly and time-consuming ventures to start and operate. Incorporating requires start-up, operating, and tax costs that most other structures do not require.
- **Double Taxing.** In some cases, corporations are taxed twice—first, when the company makes a profit, and again when dividends are paid to shareholders.
- **Additional Paperwork.** Because corporations are highly regulated by federal, state, and in some cases local agencies, there are increased paperwork and record-keeping burdens associated with this entity.

S Corporation

An S corporation (sometimes referred to as an **S Corp**) is a special type of corporation created through an IRS tax election. An eligible domestic corporation can avoid double taxation (once to the corporation and again to the shareholders) by electing to be treated as an S corporation.

An S corp is a corporation with the **Subchapter S** designation from the IRS. To be considered an S corp, you must first charter a business as a corporation in the state where it is headquartered. According to the IRS, S corporations are "considered by law to be a unique entity, separate and apart from those who own it." This limits the financial liability for which you (the owner or "shareholder") are responsible. Nevertheless, liability protection is limited—S corps do not necessarily shield you from all litigation such as an employee's tort actions as a result of a workplace incident.

What makes the S corp different from a traditional corporation (C corp) is that profits and losses can pass through to your personal tax return. *Consequently, the business is not taxed itself. Only the shareholders are taxed.* There is an important caveat, however: Any shareholder who works for the company must pay him or herself "reasonable compensation." Basically, the shareholder must be paid fair market value, or the IRS might reclassify any additional corporate earnings as "wages."

Forming an S Corporation

Before you form an S Corporation, you must determine if your business will qualify under the IRS stipulations, and you must first file as a corporation. After you are considered a corporation, all shareholders must elect your corporation to become an S corporation. As with the C corp, this process can be complex, and it's generally standard practice for an attorney with experience in corporate matters to guide the business owners/shareholders through the creation and registration of the S corp.

S Corporation Taxes

Like the C corp, S corps need to register with the IRS, register with state and local revenue agencies, and obtain a tax ID number or permit.

However, unlike the C corp, all states *do not* tax S corps equally. Although most state taxing authorities treat them similarly to the federal government (IRS) and tax the shareholders accordingly, some states (like Massachusetts) tax S corps on profits above a specified limit. Other states don't recognize the S corp at all, and they treat the business as a C corp with all of the tax ramifications. Some states (like New York and New Jersey) tax both the S corps profits and the shareholder's proportional shares of the profits. Before deciding upon a corporate structure, business owners/shareholders need to check with an accounting professional to ensure that they make the proper election based on their state corporate tax laws.

Advantages of an S Corporation

- **Tax Savings**. One of the best features of the S corp is the tax savings for you and your business. While members of an LLC are subject to employment tax on the entire net income of the business, only the wages of the S corp shareholder who is an employee are subject to employment tax. The remaining income is paid to the owner as a "distribution," which is taxed at a lower rate, if at all.
- **Business Expense Tax Credits.** Some expenses that shareholder/employees incur can be written off as business expenses. Nevertheless, if such an employee owns 2 percent or more shares, then benefits like health and life insurance are deemed taxable income.
- **Independent Life.** An S corp designation also allows a business to have an independent life, separate from its shareholders. If a shareholder leaves the company, or sells his or her shares, the S corp can continue doing business relatively undisturbed. Maintaining the business as a distinct corporate entity defines clear lines between the shareholders and the business that improve the protection of the shareholders.

Disadvantages of an S Corporation

- **Stricter Operational Processes.** As a separate structure, S corps require scheduled director and shareholder meetings, minutes from those meetings, adoption and updates to by-laws, stock transfers, and records maintenance.
- **Shareholder Compensation Requirements.** A shareholder must receive reasonable compensation. The IRS takes notice of shareholder red flags like low salary/high distribution combinations, and may reclassify your distributions as wages. You could pay a higher employment tax because of an audit with these results.

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1. http://www.businessnewsdaily.com/873...rporation.html ↵
2. http://benefitcorp.net/sites/default...icers_6_17.pdf ↵

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7.6: Hybrid Forms of Ownership

What you'll learn to do: discuss the advantages and disadvantages of hybrid forms of business ownership

The concept of "limited liability" has given rise to hybrid forms of business ownership such as LLCs and LLPs. In this section you'll learn what these forms are and the pros and cons of each.

Learning Objectives

- Discuss the advantages and disadvantages of LLPs
- Discuss the advantages and disadvantages of LLCs

Limited Liability Partnership (LLP)

A **limited liability partnership (LLP)** is a partnership in which some or all partners (depending on the jurisdiction) have limited liabilities. It therefore exhibits elements of partnerships and corporations. In an LLP, one partner is not responsible or liable for another partner's misconduct or negligence.

In an LLP, some partners have a form of limited liability similar to that of the shareholders of a corporation. Some states require one partner to be a "general partner" with unlimited liability, meaning he/she is ultimately responsible for the debts of the business and for any lawsuits such as personal injury or breach of contract. Unlike corporate shareholders, the partners have the right to manage the business directly. In contrast, corporate shareholders have to elect a board of directors under the laws of various state charters. The board organizes itself (also under the laws of the various state charters) and hires corporate officers who, as "corporate" individuals, then have the legal responsibility to manage the corporation in the corporation's best interest. An LLP also has a different level of tax liability compared with that of a corporation.

As in a partnership or limited liability company (LLC), the profits of an LLP are allocated among the partners for tax purposes, avoiding the problem of "double taxation" often found in corporations.

Forming an LLP

Verify Eligibility Status. In the United States, each individual state has its own law governing the formation of LLPs. Although found in many business fields, the LLP is an especially popular form of organization among professionals such as lawyers, accountants, and architects. In California, New York, Oregon, and Nevada, LLPs can only be formed for such professional uses.

Choose a Business Name. When selecting a name for the LLP, generally the name (1) must be different from an existing LLP in your state, and (2) most states require the inclusion of "Limited Liability Partnership," "LLP," or another related abbreviation at the end of your business name.

Draft a Limited Liability Partnership Agreement. Although not required in every state, this agreement is strongly recommended. A limited liability partnership agreement should define each partner's role and responsibilities. It should clearly define the partners' assets and liability limitations. The agreement should also outline capital contributions, distribution of profits and losses, buyout agreements, expulsion or addition of partners, etc.

File a Certificate of Limited Liability Partnership. The drafting of an LLP agreement is optional; however all LLPs must file a certificate of limited liability partnership (sometimes called a certificate of registration as a limited liability partnership). The certificate of limited liability partnership is more general than the limited liability partnership agreement, as it does not detail responsibilities, capital contributions, buyouts, etc. The certificate requires the listing of your business's name and address, the names and contact information of the partners, and information on the registered agent of the LLP.

Obtain Licenses and Permits. Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state and locality.

Announce Your Business. Some states, including Arizona and New York, require the extra step of publishing a statement in your local newspaper about your LLP formation.

LLP Taxes

The tax treatment for LLPs is similar to general partnerships, as discussed earlier. Profits and losses are passed through to the partners so the partners reflect them on their individual tax return.

Advantages of an LLP

- **Single Taxation**. The credits and deductions of the company are passed through to partners to file on their individual tax returns. Credits and deductions are divided by the percentage of individual interest each partner has in the company.
- **Limited Liability.** The LLP structure protects individual limited partners from personal liability for negligent acts of other partners or employees not under their direct control. In addition, individual partners are not personally responsible for company debts or other obligations.
- **Flexibility**. LLPs provide the partners flexibility in business ownership. Partners have the ability to decide how they will individually contribute to business operations, both financially and physically. Management duties can be divided equally or unequally based on the experience of each partner. Partners who have a financial interest in the company can elect not to have any authority over business decisions but still maintain ownership rights based on their percentage interest in the company.

Disadvantages of an LLP

- **Duration**. The business life of a LLP is unstable because the partnership can be dissolved by agreement of the partners or upon the death or withdrawal of a partner. A limited liability partnership agreement can prevent dissolution if a partner dies or withdraws.
- **Limitation of Formation**: Unlike general partnerships, limited liability partnerships are not recognized as legal business structures in every state. Some states limit the creation of a limited liability partnership to professionals such as doctors or lawyers.
- **Partner Control.** If an LLP is formed without a limited liability partnership agreement, individual partners are not obligated to consult with other participants in certain business agreements. The fact that a partner can make business decisions without consulting the other partners can be problematic, to say the least.

Limited Liability Company (LLC)

A limited liability company (LLC) is a hybrid business structure allowed by state statute. LLCs are attractive to small business owners because they provide the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. *Each state may use different regulations*, and you should check with your state if you are interested in starting a limited liability company.

Owners of an LLC are called members. Most states do not restrict ownership, and so members may include individuals, corporations, other LLCs and foreign entities. There is no maximum number of members. Most states also permit “single-member” LLCs, those having only one owner.

Unlike shareholders in a corporation, LLCs are not taxed as a separate business entity. Instead, all profits and losses are “passed through” the business to each member of the LLC. LLC members report profits and losses on their personal federal tax returns, just like the owners of a partnership would.

Forming an LLC

While each state has slight variations on forming an LLC, they all adhere to some general principles:

Choose a Business Name. There are three rules that your LLC name needs to follow: (1) it must be different from an existing LLC in your state, (2) it must indicate that it’s an LLC (such as “LLC” or Limited Company”) and (3) it must not include words restricted by your state (such as “bank” and “insurance”). Your business name is automatically registered with your state when you register your business, so you do not have to go through a separate process.

File the Articles of Organization. The “articles of organization” is a simple document that legitimizes your LLC and includes information like your business name, address, and the names of its members. For most states, you file with the Secretary of State. However, other states may require that you file with a different office such as the State Corporation Commission, Department of Commerce and Consumer Affairs, Department of Consumer and Regulatory Affairs, or the Division of Corporations & Commercial Code.

Create an Operating Agreement. Most states do not require operating agreements. However, an operating agreement is highly recommended for multimember LLCs because it structures your LLC’s finances and organization, and provides rules and regulations for smooth operation. The operating agreement usually includes percentage of interests, allocation of profits and losses, member’s rights and responsibilities, and other provisions.

Obtain Licenses and Permits. Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state, and locality.

Announce Your Business. Some states, including Arizona and New York, require the extra step of publishing a statement in your local newspaper about your LLC formation.

LLC Taxes

In the eyes of the federal government, an **LLC is not a separate tax entity,** so the business itself is not taxed. Instead, all federal income taxes are passed on to the LLC's members and are paid through their personal income tax. While the federal government does not tax income on an LLC, some states do, so check with your state's income tax agency.

Since the federal government does not recognize LLC as a business entity for taxation purposes, all LLCs must file as a corporation, partnership, or sole proprietorship tax return. Certain LLCs are automatically classified and taxed as a corporation by federal tax law.

Advantages of an LLC

- **Limited Liability**. Members are protected from personal liability for business decisions or actions of the LLC. This means that if the LLC incurs debt or is sued, members' personal assets are usually exempt. This is similar to the liability protections afforded to shareholders of a corporation. Keep in mind that limited liability means "limited" liability—members are not necessarily shielded from wrongful acts, including those of their employees.
- **Less Record Keeping.** An LLC's operational ease is one of its greatest advantages. Compared to an S Corporation, there is less registration paperwork and there are smaller start-up costs. However, it is very important to keep proper and separate business financial records. If it appears that the LLC is co-mingling personal and business funds, it can be legally reclassified and end up assuming additional liability.
- **Sharing of Profits.** There are fewer restrictions on profit sharing within an LLC, as members distribute profits as they see fit. Members might contribute different proportions of capital and sweat equity. Consequently, it's up to the members themselves to decide who has earned what percentage of the profits or losses.

Disadvantages of an LLC

- **Possible Limited Life.** When an LLC is formed, the members must decide on the duration of the LLC. If an LLC is formed in a state where perpetual life is not permitted, then the death or disassociation of a member will dissolve the LLC, and the members must fulfill all remaining legal and business obligations to close the business. For this reason, it is important for individuals seeking to use this form of ownership verify the requirements for an LLC in the state in which they intend to operate.
- **Self-Employment Taxes.** Members of an LLC are considered self-employed and must pay the self-employment tax contributions towards Medicare and Social Security. The entire net income of the LLC is subject to this tax.

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7.7: Franchises

What you'll learn to do: discuss the advantages and disadvantages of franchises

For aspiring business owners who lack the time, vision, or resources to start from scratch, franchising is a viable alternative. Everyone is familiar with franchises—many industries such as fast food are almost wholly comprised of franchises. As appealing as it may seem, there are still risks to franchising for both the franchisor and franchisee.

Learning Objectives

- Discuss the advantages and disadvantages of franchising for the franchisee
- Discuss the advantages and disadvantages of franchising for the franchisor

Franchises

A **franchise** is a business model that involves one business owner (the **franchisor**) licensing trademarks and methods to an independent entrepreneur (the **franchisee**) for a prescribed period of time. For the franchisor, the franchise is an alternative to expanding through the establishment of a new location, which avoids the financial investment and liability of a chain of stores. Ultimately, the franchisor's success depends on the success of the franchisees. If the franchisees are successful then the franchisor can grow its brand and market presence while the franchisee, in effect, does all of the work.

The United States is a leader in franchising, a position it has held since the 1930s when it used the approach for fast-food restaurants, food inns, and, slightly later, motels during the time of the Great Depression. Today, the world's largest franchise chains are U.S. companies:

- **Subway**: start-up costs $84,300–$258,300; 41,916 locations worldwide in 2015
- **McDonald's**: start-up costs in 2010: $995,900–$1,842,700; 36,368 Locations in 2015
- **7-Eleven Inc.**: start-up costs in 2010: $40,500–$775,300; 56,439 locations in 2015
- **Hampton Inns & Suites:** start-up costs in 2010: $3,716,000–$15,148,800
- **Great Clips:** start-up costs in 2010: $109,000 – $203,000; 3,694 locations in 2015

Buying a Franchise

The decision to purchase a franchise involves many factors, including how much you can afford to invest, what abilities you have, and what your goals are. Before you decide to purchase a franchise, it's important to do thorough research. You could lose a significant amount of money if you don't investigate a business carefully before you buy. By law, franchisors must disclose certain information about their business to potential buyers. Make sure you get all the information you need first before entering into this form of business.

The following strategies can help you gain a solid understanding of what to expect as well as the risks that could be involved:

- **Be a Detective.** In addition to the routine investigation that should be conducted prior to any business purchase, you should be able to contact other franchisees before deciding to invest. You can obtain a Uniform Franchise Offering Circular (UFOC), which contains vital details about the franchise's legal, financial, and personnel history, before you sign a contract.
- **Know What You Are Getting Into.** Before entering into any contract as a franchisee, you should make sure that you would have the right to use the franchise name and trademark, receive training and management assistance from the franchisor, use the franchisor's expertise in marketing, advertising, facility design, layouts, displays and fixtures, and do business in an area protected from other competing franchisees.
- **Watch Out for Possible Pitfalls.** The contract between the two parties usually benefits the franchisor far more than the franchisee. The franchisee is generally subject to meeting sales quotas and is required to purchase equipment, supplies, and inventory exclusively from the franchisor.
- **Seek Professional Help.** The tax rules surrounding franchises are often complex, and an attorney, preferably a specialist in franchise law, should assist you to evaluate the franchise package and tax considerations. An accountant may be needed to determine the full costs of purchasing and operating the business as well as to assess the potential profit to the franchisee.

Franchise Taxes

The taxation of a franchise depends on the underlying form of ownership. Generally franchises are required by the franchisor to be established as a corporation or LLC. Ultimately, the franchise agreement governs this, and individuals looking to purchase a franchise should scrutinize any agreements with regard to prescribed legal ownership structure.

Advantages for the Franchisor

- **Access to Capital for Growth and Expansion.** After the brand and formula are carefully designed and properly executed, franchisors are able to sell franchises and expand rapidly across countries and continents using the capital and resources of their franchisees.
- **Cash Flow for Operations.** In addition to initial franchise fees that can range from $50,000 to $5 million, franchisors receive payments in the form of royalties from each franchisee. These royalties typically range from 4 percent to 8 percent of gross revenues. In addition, franchisees are also assessed for marketing and advertising.
- **Economies of Scale**. Once a franchise is established with multiple locations, the company may be able to leverage its buying power to realize economies of scale with suppliers, advertisers, and vendors. If purchasing and distribution for the franchise locations can be centralized, then the cost savings will increase the franchisor's bottom line, particularly if the franchise agreement provides for a percent-of-sales payment to the franchisor.

Disadvantages for the Franchisor

- **Lack of Control.** Despite the language of the franchise agreement, once the franchisee has established their location, the franchisor may have difficulty ensuring that quality standards are met and the franchise is operating in a manner that benefits the brand. A Dunkin' Donuts franchise in Russia had to be closed after it was discovered that instead of serving donuts and coffee, the franchisee was serving vodka and meat pies.
- **Trade Secrets.** If the success of a business is based on a trade secret, special process, or innovative technology, establishing a franchise may make the business vulnerable to knock-offs or imitation. Although the franchise agreement specifically prohibits the disclosure of trade secrets, the fact that the franchisee may see opportunities to improve upon the process and become a competitor is not expressly prohibited.
- **Overexposure, Brand Dilution**. One or two locations of a business is unique and may generate enough demand that the business can charge top dollar for goods or services. When franchises appear on almost every street corner, the allure of the business may fade and the brand or business may suffer.

Advantages for the Franchisee

- **Less Risk.** In certain industries, when compared with starting one's own business from scratch, buying a franchise enables the franchisee to own a business with a proven track record and an established market presence, thereby reducing the risk of failure. However, purchasing a franchise still doesn't guarantee success, and many franchisees go out of business, losing their initial investment and start-up capital.
- **Name/Brand Recognition.** The franchise has an established image and identity already, which can reduce or simplify marketing efforts. Many franchises are nationally advertised brands, shortening the time it takes for the franchisee to establish a market presence.
- **Access to Expertise, Ongoing Support.** Franchisee often receives help with site selection, training materials, product supply, and marketing plans. The franchisee gets to take advantage of a business model whose strategies and processes have already been tested and streamlined.
- **Relative Autonomy.** Franchisee must comply with the terms and standards of the franchisor, but otherwise has a fair amount control over the day-to-day operations of the franchise.

Disadvantages for the Franchisee

- **Cost**. Buying and running a franchise can be very expensive. Jimmy John's Subs was listed as one of the top franchises in 2016, but the initial investment to open a location was $325,000–$555,000. Franchise fees generally run in the $20,000-to-$30,000 range, though they can top $100,000 for higher-end, more established brands. Once open, there are ongoing royalties to pay, which typically range from 4 percent to 8 percent of gross revenues and include an ongoing assessment for marketing and advertising.
- **Unequal Partnership**. The franchisor sets the rules, and the franchisee must follow them. The franchisee doesn't have much leverage if the franchisor falls short on promises or makes unreasonable demands.
- **Rules and Enforcement.** Franchisor rules imposed by the franchising authority are becoming increasingly strict. Some franchisors are using minor rule violations to terminate contracts and seize the franchise without any reimbursement. Often this

happens when a franchise location becomes very profitable or the franchisor sees an opportunity to profit by seizing and liquidating the location.

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7.8: Mergers and Acquisitions

What you'll learn to do: describe the two types of mergers and acquisitions

One of the quickest ways for a business to expand into other markets or products lines is either to merge or acquire/purchase another company. Although this is common in today's business environment, there are still many complex factors to consider before deciding whether a merger or acquisition is the optimal solution.

Learning Objectives

- Define acquisition as a business strategy
- Explain why companies undertake vertical mergers and acquisitions

Mergers and Acquisitions

Integration Strategies: Mergers and Acquisitions

When businesses acquire other businesses or operations that were previously competitors, suppliers, buyers, or sellers, they are engaging in a strategy known as **integration**. This strategy is based on the possibility of synergy, the idea that the sum of two entities will be greater than their individual parts—often expressed as 1 + 1 = 3. Integration can be accomplished in two primary ways: through mergers or acquisitions. A merger is the consolidation of two companies that, prior to the merger, were operating as independent entities. A **merger** usually creates one larger company, and one of the original companies ceases to exist. Mergers can be either horizontal or vertical.

A **horizontal merger** occurs between companies in the same industry. This type of merger is essentially a consolidation of two or more businesses that operate in the same market space, often as competitors offering the same good or service. Horizontal mergers are common in industries with fewer firms, since competition tends to be higher, and the synergies and potential market-share gains are much greater in those industries.

facebook + Instagram = horizontal merger

When Facebook acquired Instagram in 2012 for a reported $1 billion, Facebook was looking to strengthen its position in the social-media and social-sharing space. Both Facebook and Instagram operated in the same industry and were in similar positions with regard to their photo-sharing services. Facebook clearly saw Instagram as an opportunity to grow its market share, increase its product line, reduce competition, and access new markets.

A **vertical merger** is characterized by the merger of two organizations that have a buyer-seller relationship or, more generally, two or more firms that are operating at different levels within an industry's supply chain. Most often the logic behind the merger is to increase synergies by merging firms that would be more efficient operating as one.

apple: The King of Vertical Integration

Apple Inc. is famous for perfecting the art of vertical integration. The company manufactures its custom A-series chips for its iPhones and iPads. It also manufactures its custom touch ID fingerprint sensor. Apple opened up a laboratory in Taiwan for the development of LCD and OLED screen technologies in 2015. It also paid $18.2 million for a 70,000-square-foot manufacturing facility in North San Jose in 2015. These investments (i.e., mergers) enable Apple to move along the supply chain in a backward integration, giving it flexibility and freedom in its manufacturing capabilities.[1]

An **acquisition**, on the other hand, occurs when a company purchases the assets of another business (such as stock, property, plants, equipment) and usually permits the acquired company to continue operating as it did prior to the acquisition. *Acquisition* usually refers to a purchase of a smaller firm by a larger one. Sometimes, however, a smaller firm will acquire management control of a larger and/or longer-established company and retain the name of the latter for the post-acquisition combined entity.

Reasons for Mergers and Acquisitions

There are many good reasons for growing your business through an acquisition or merger. These include:

1. Obtaining quality staff or additional skills, knowledge of your industry or sector, and other business intelligence. For instance, a business with good management and process systems will be useful to a buyer who wants to improve their own. Ideally, the business you choose should have systems that complement your own and that will adapt to running a larger business.
2. Accessing funds or valuable assets for new development. Better production or distribution facilities are often less expensive to buy than to build. Look for target businesses that are only marginally profitable and have large unused capacity that can be bought at a small premium-to-net-asset value.
3. Your business is underperforming. For example, if you are struggling with regional or national growth, it may well be less expensive to buy an existing business than to expand internally.
4. Accessing a wider customer base and increasing your market share. Your target business may have distribution channels and systems you can use for your own offers.
5. Diversification of the products, services, and long-term prospects of your business. A target business may be able to offer you products or services that you can sell through your own distribution channels.
6. Reducing your costs and overheads through shared marketing budgets, increased purchasing power, and lower costs.
7. Reducing competition. Buying up new intellectual property, products, or services may be cheaper than developing these yourself.
8. Organic growth (i.e., the existing business plan for growth needs to be accelerated). Businesses in the same sector or location can combine resources to reduce costs, eliminate duplicated facilities or departments, and increase revenue.

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1. http://www.investopedia.com/terms/v/...#ixzz4PRMbV5zm ↵

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7.9: Putting It Together- Business Ownership

Synthesis

Now that you have come to the end of this module, you should understand that there is a range of possibilities for structuring, starting, and growing a business. Each choice has its advantages and disadvantages, and there is no single set of choices that will accommodate all businesses. Just knowing that there are choices to be made and a variety of possible paths is critical to the success of any business venture—large or small.

Summary

In this module you learned about the various legal forms for a business and the advantages and disadvantages of each. The following are key takeaways from this module:

Choosing an Organizational Type

Sole proprietorship, partnerships, corporations, and hybrids (LLC, LLP) are all possible options for the legal formation of a business. Each structure carries risks and rewards, costs and benefits. Which form of business ownership is best for an individual depends not only upon the nature of the business opportunity but also the level of personal exposure to risk the owner is willing to accept.

Sole Proprietorships

Sole proprietorships are the simplest and most common legal structure for a business. These businesses are owned and run by one person.

Partnerships

A partnership is a single business in which two or more people share ownership. There are two general types of partnership arrangements: general partnerships and limited partnerships.

Corporations

Although not the most *common* form of business ownership, corporations account for the majority of the *revenue* from business in the U.S. They are also the most complex type of organization to start and maintain. Types of corporations include C corporations, S corporations, and B corporations.

Hybrid Forms of Ownership

Fortunately there are options that enable the business owner to take advantage of limited personal liability and the benefits of partnership or corporate organization. These include the limited liability corporation (LLC) and limited liability partnership (LLP). Which type of ownership an owner selects will largely be determined by the size, objectives, and vision for the business.

Let's take a look at how these different forms of ownership compare to one another.

	Sole Proprietorship	Partnership	LLC	LLP	Corporation	S Corporation
Owner(s)	1 sole proprietor	2 or more partners	1 or more members	2 or more partners	1 or more shareholders	1 or more shareholders
Sole authority for decisions	Yes	No	No* *Yes, if only one member	No	No* *Yes, if only one shareholder	No* *Yes, if only one shareholder
Easy setup	Yes	Yes	Yes	Yes	No	No
Minimal regulations	Yes	Yes	Yes	Yes	No	No
Single taxation	Yes	Yes	Yes	Yes	No	Yes
Easy access to expertise	No	Somewhat	Somewhat	Somewhat	Yes	Yes

	Sole Proprietorship	Partnership	LLC	LLP	Corporation	S Corporation
Easy access to capital	No	Somewhat	Somewhat	Somewhat	Yes	Yes
Limited legal liability	No	No	Yes	Yes	Yes	Yes
Unlimited life	No	No	Possible	Possible	Yes	Yes
Easy transfer of ownership	No	No	No	No	Yes	Yes

Franchising

For aspiring business owners who do not have the time, vision, or resources to "start from scratch," franchising is a viable alternative for business ownership. Everyone is familiar with franchises—many industries such as fast food are almost wholly comprised of franchises. As appealing as this may seem, there are still risks to franchising for both the franchisor and franchisee.

Mergers and Acquisitions

One of the quickest ways for a business to expand into other markets or products lines is either to merge or acquire/purchase another company. Although this is common in today's business environment, there are still many complex factors to consider before deciding whether a merger or acquisition is the optimal solution.

Additional Resources

U.S. Small Business Association (SBA) website

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CHAPTER OVERVIEW

8: Entrepreneurship

8.1: Why It Matters- Entrepreneurship
8.2: Small Business
8.3: Entrepreneurs
8.4: Advantages, Disadvantages, and Considerations
8.5: Steps on Starting a Business
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8.1: Why It Matters- Entrepreneurship

Why discuss the role of entrepreneurship in small business?

Figure 8.1.1. What do all of these items have in common? They all represent the efforts of entrepreneurs.

The American psyche often equates size with success, applying a “get big or get out” standard to industries ranging from agriculture and energy to social enterprise. Indeed, that phrase (decades before a variation became associated with living large) was the mantra of Secretary of Agriculture Earl Butz, whose policy changes supported the growth of major agribusiness corporations at the expense of the small family farm. And yet if American history has taught us anything, it’s that we are in charge of our destiny and our definition of success. And that success can be achieved at any size and from any number of incubators (kitchen, garage, dorm room) and ad hoc office spaces.

Large financial institutions and corporations are often considered to be the engines of our economy, but big business is only—literally—half of the story. While the majority of small businesses don’t operate at scale (roughly 70 percent have less than 100 employees) their cumulative economic impact is significant. Through inventions and innovations, entrepreneurs also shape how and how well we communicate, learn, live and experience life. Entrepreneurship matters not only because of the employment and productivity impact, but because small businesses contribute to the resilience of their communities and the nation and, by extension, to stability globally.

In this module, we’ll define small businesses and entrepreneurship, provide perspective on the opportunities and the risks, discuss common motivations and traits and finally the steps involved in developing a business plan.

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8.2: Small Business

What you'll learn to do: Discuss the contributions of small business to the U.S. economy

Individual business ownership is a fundamental aspect of the American dream. Through the lens of award-winning documentary filmmaker Ken Burns: "Entrepreneurship is at the heart of who we are in terms of the American promise and the American dream."

In this section, we'll discuss the definition and significance of the term "small business" and explore the impact small business has had on the U.S. economy.

Learning Objectives

- Discuss the contributions of small businesses to the U.S. economy

Understanding Small Businesses

The U.S. Small Business Association, referred to as the "SBA," is the go-to source for all things small business—including the statutory definition of a small business. Classification as a small business is determined by size standards—either number of employees or revenue—based on industry. Specifically, size standards are based on the 6-digit "NAICS" or North American Industry Classification System code that describes a business's economic activity. Note that the form or legal structure of a business (e.g., sole proprietor, limited liability corporation (LLC), partnership, or corporation) is not a factor in determining whether an enterprise is a small business.

For manufacturing businesses, the standard is generally number of employees, with maximums ranging from 500 to 1,500. For example, the employee maximum for a commercial bakery is 1,000 and for a business brewery, 1,250. For nonmanufacturing industries—think retailers and wholesalers—the standard is based on a three-year average of annual revenue, with the maximum ranging from $750,000 for agriculture enterprises to $38,500,000 for Electronic Shopping and Mail-Order Houses, Hospitals and Building Material and Garden Home Centers. The small business size standard for professional services (NAICS prefix 541) ranges from $7,500,000 for Architectural Services to $38,500,000 for Military and Aerospace Engineering. Research activities are subject to an employee standard. Financial institutions are an exception to the employee or revenue rule; commercial banks, savings institutions and credit unions are subject to a $550 million asset limitation. Clearly, small is relative! Note that size standards change periodically (above data is current as of 10/4/2018). For the most recent criteria information, refer to the source: Code of Federal Regulations (eCFR) Part 121-Small Business Size Regulations, Section 121.201; direct link: Small Business Size Standards by NAICS Industry

Another determination option is to use the SBA's interactive Size Standards Tool. This tool is designed to answer the question "Are you a small business eligible for government contracting?" The tool provides a determination of either Yes ("you may be") or No, with the relevant small business size standard. To use this tool, you need to know your NAICS code or codes (multiple selections allowed). You can use the search tool on the census.gov site to determine the NAICS code(s) associated with your primary business activity (activities).

As alluded to above, classification as a small business matters because the SBA size standard is used to determine whether a business, including any affiliates or subsidiaries, is eligible to participate in SBA and federal contracting programs. This eligibility can have significant financial implications, from obtaining access to financing, including access to loans, investment capital and grants to preferential access to government contracts, totaling $392.4B (billion!) in eligible dollars in 2018.

In addition to meeting the relevant numerical size standard, a business must also meet the following criteria in order to be eligible for SBA and government contracting programs:

- For-profit enterprise
- Independently owned & operated
- Physically located & operating in the United States or its territories
    - If located outside the United States, it must maintain a US operation and make a significant contribution to the US economy through the payment of taxes or use of American labor, materials, or products
- Not in a dominant market position nationally

practice question 8.2.1

Which of the following determines if a business is to be defined as a "Small Business"?

a. form or legal structure of a business, such as Sole Proprietor, Limited Liability Corporation, or Partnership
b. company assets and year in business
c. number of employees or revenue, based on the category of the economic activity
d. approval from the Small Business Administration (SBA) based on relevant IRS documents

Answer

c. The size standard dictates that either number of employees (manufacturing activities) or revenue (retailers, wholesalers, agriculture) determines if a business can be classified as a small business

learn more

For perspective, the value of small business contracts rose from $100.1 billion in fiscal 2016 to $105.9 billion in fiscal 2017. To see data by year and category (e.g., Women Owned, Small Disadvantaged Business, Service Disabled Veteran) view the source at Small Business Dashboard. For additional information on federal contracting, visit the SBA's Federal Contracting page.

Contributions of Small Businesses on the U.S. Economy

When the Small Business & Entrepreneurship Council states that "American business is overwhelmingly small business," it's not just hype. According to the U.S. Small Business Administration, there are over 30 million small business in the United States, with small businesses accounting for 99.9% of all businesses. Small businesses play a crucial role in the US economy, responsible for roughly half of new job creation and economic activity, measured by GDP or Gross Domestic Product. Small businesses employ approximately 60 million Americans, or 47.5% of all U.S. employees. Embedded in the community, small businesses also drive local economic growth and vitality. There's a multiplier effect—an additional economic benefit that accrues to the community—when people spend locally. For example, If you spend $100 at a locally-owned business, $68 stays in the community. If you spend $100 at a national chain, only $43 stays in the community.

Small businesses are not only economic engines, they represent a source of innovation. In an article for Inc., Babson College entrepreneurship professor Patricia Green refers to small businesses as "the innovators of the world." In research done with Goldman Sachs 10,000 Small Business Program participants, Green found that the small-business owners were actively engaged in pursuing opportunities that met one or more of the innovation criteria established by economist and author Joseph Schumpeter:

1. new products
2. new methods
3. new markets
4. new sources of supply
5. new market structures

Entrepreneurs have conceived many of our most beloved products, including beer, chocolate chip cookies, Monopoly and personal computers. More recent innovations include a 3D printer for fabricating living cells, charitable crowdfunding, disinfectant light fixtures, artery stents, microfinance, non-toxic paints, and Structural Insulated Panels (SIPs).

Small businesses are as unique as the individuals that start them. Starting your own business allows you to develop a business concept and future vision that achieves your specific definition of "success." And different entrepreneurs will pursue different paths in achieving that vision.

practice question 8.2.2

The two most important contributions made by small businesses to the U.S. economy are:

a. Innovation and internships
b. Economic activity and social growth
c. Economic activity and innovation
d. Job training and working capital

Answer

c. Small business accounts for 99% of all U.S. businesses (economic activity) and are the "innovators of the world" (innovation)

biosip

Award-winning architect and Colorado University architecture professor Julee Herdt is developing and testing her green building innovations primarily in the academic environment, using collegiate home design competitions as proof of concept. Herdt's BioSIP invention was cited by the international Solar Decathlon judges as being critical to the CU team's back-to-back (2002, 2005) wins in the Solar Decathlon competition.

Since those awards, Herdt has advanced BioSIPs structural insulated wall, floor and roof panels to exhibit strengths surpassing other SIPs in specific areas (compressive and transverse loading) as well as to exhibit super thermal values.

Herdt has been awarded 2 patents and her BioSIPs inventions have garnered a State of Colorado, US Green Building Council (USGBC) "New Products" and "Excellence in Renewable Energy in Buildings" awards and numerous grant awards.

Herdt is CEO of BioSIPs, Inc., a woman-owned tech-based corporation and CU's technology spin-off for commercialization of BioSIPs and other products from 100 percent diverted waste fibers.

lisnr

LISNR CEO Rodney Williams co-founded Lisnr, a technology start-up, while he was still working at Procter & Gamble. Technology wasn't new to him; he had 3 patents by the age of 27.

Williams, who had a vision for the Lisnr technology, met co-founder Chris Ostoich at P&G. The two co-found took their idea on The Startup Bus, a 72-hour technology business concept competition. The team met their third co-founder and first investor at South by Southwest, where the aspiring entrepreneurs made their pitches to business scouts and investors.

Their journey includes a number of lessons and cash flow challenges—common challenges for entrepreneurs. Read Williams' CNBC profile or watch the video for perspective on lessons learned on his journey from a six-figure corporate salary to $100,000 in debt to now, with 40 employees and founding of over $14 million. LISNR leadership was named a 2017 E&Y Entrepreneur of the Year.

additional reading

- Time’s 25 Best Inventions of 2017.
- Inc. The 14 Coolest Products From Millennial Entrepreneurs

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8.3: Entrepreneurs

What you'll learn to do: identify the common traits of successful entrepreneurs

Free enterprise or entrepreneurship is ingrained in both the American legal system and psyche. There is a cultural ideal that people will be rewarded equitably for the work they put forth (though it's certainly up for debate how accurately this ideal reflects reality). This ideal is often what prompts entrepreneurship: the idea that one person can work hard enough to make a good idea a successful company, product, or service.

Although one's "entrepreneurial DNA" and definition of success may vary, entrepreneurship is universally an act of self-actualization. In this section, we'll explore what it means to be an entrepreneur, from definition to categories, traits and motivation.

Learning Objectives

- Identify the common traits of successful entrepreneurs
- List common reasons for choosing to be an entrepreneurs

What Is an Entrepreneur?

> *"An entrepreneur is someone who has a bias towards action. Someone who views the world through a different lens. Someone who takes 'no' for a challenge, not an answer."*
>
> *—Matt Mickiewicz, Owner of 99Designs.com, Flippa.com & Sitepoint.com*

Merriam-Webster defines an entrepreneur as "one who organizes, manages, and assumes the risks of a business or enterprise." What's missing—or perhaps understated—in this definition is the importance of initiative. That is to say, grammar aside, entrepreneur is a verb. Given this, it might be more accurate to define an entrepreneur as someone who sees an opportunity—some hole in the market, or some way to better provide a current service—and works effectively to create a solution, carefully designing how the solution will be made and distributed.

In expressing an insider's perspective, Atari and Chuck E. Cheese Founder Nolan Bushnell captures both the initiative and sense of urgency that is part of the entrepreneur's DNA: "A lot of people have ideas, but there are few who decide to do something about them now. Not tomorrow. Not next week. But today. The true entrepreneur is a doer, not a dreamer."

practice question 8.3.1

Given the multiple definitions in this section, what is the most important common quality that captures the essence of the "entrepreneur"?

a. promise of opportunity
b. viewer through a different lens
c. creator of ideas
d. bias for action

Answer

d. The entrepreneur is a doer

Example 8.3.1: young entrepreneur living the dream

Jack Bonneau is the quintessential entrepreneur. In the three years he has been in business, he has expanded his product line, opened multiple locations, established strategic partnerships, and secured sponsorship from several national brands. His business has garnered publicity from *The New York Times*, *The Denver Post*, *The Today Show*, *Good Morning America*, and numerous other media. He has shared his business success on several stages, speaking at TechStars and the Aspen Ideas Festival,

and recently delivered the closing keynote speech at a national STEM conference. He even landed a gig on *Shark Tank*.

Jack Bonneau is smart, charismatic, an excellent spokesperson, and persistent in his mission. And he is only 11 years old—which also makes him very adorable.

Jack's business was born from a need that most kids have: a desire for toys. He asked his dad, Steve Bonneau, for a LEGO Star Wars Death Star. The problem was that it cost $400. Jack's dad said he could have it but only if he paid for it himself. This led Jack to do what a lot of kids do to earn some extra cash. He opened a lemonade stand. But he quickly learned that this would never help him realize his dream, so, with the advice and help of his father, he decided to open a lemonade stand at a local farmers market. "There were lots of people who wanted to buy great lemonade from an eight-year-old," says Jack. In no time, Jack had earned enough to buy his LEGO Death Star. "I had sales of around $2,000, and my total profit was $900," Jack said.

Jack realized that he was on to something. Adults love to buy things from cute kids. What if he could make even more money by opening more locations? Jack developed an expansion plan to open three new "Jack Stands" the following spring. Realizing that he would need more working capital, he secured a $5,000 loan from Young Americas Bank, a bank in Denver that specializes in loans to children. Jack made $25,000 in 2015.

The following year, Jack wanted to expand operations, so he secured a second loan for $12,000. He opened stands in several more locations, including shopping malls during the holiday season, selling apple cider and hot chocolate instead of lemonade. He also added additional shop space and recruited other young entrepreneurial kids to sell their products in his space, changing the name to Jack's Stands and Marketplace. One of his first partnerships was Sweet Bee Sisters, a lip balm and lotion company founded by Lily, Chloe, and Sophie Warren. He also worked with 18 other young entrepreneurs who sell a range of products from organic dog treats to scarves and headbands.

Jack's strategy worked, and the business brought in more than $100,000 last year. This year, he became the spokesperson for Santa Cruz Organic Lemonade, and he's now looking at expanding into other cities such as Detroit and New Orleans.

Even though Jack is only 11 years old, he has already mastered financial literacy, customer service, marketing and sales, social skills, and other sound business practices—all the qualities of a successful entrepreneur.

Sources

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Common Traits of Entrepreneurs

> *"The only skills you need to be an entrepreneur: an ability to fail, an ability to have ideas, to sell those ideas, to execute on those ideas, and to be persistent so even as you fail you learn and move onto the next adventure."*
>
> *—James Altucher*

As Joe Abraham found in his research, there's no blueprint for entrepreneurial success. There are, however, common characteristics of successful entrepreneurs. In Harvard Business Review's Entrepreneurs Handbook, the editors draw on research from multiple authors, organizing these common denominators in 5 categories:

1. Ideas & Drive
2. People Skills
3. Work Style
4. Financial Savvy
5. Entrepreneurial Background

Ideas and drive—creativity, vision and an ability to identify opportunities, in particular—are the elements without which there is no entrepreneurial venture. People skills include not only leadership but the ability to build networks, communicate an inspiring vision and influence people. Critical work style traits include a goal and planning orientation, a tolerance for uncertainty, a boot-strapping mindset, a commitment to continuous improvement, resilience and core business and relationship characteristics such as the ability to close a deal and accept advice. While in-depth accounting expertise isn't required, entrepreneurs should have a basic understanding of financial statements and associated concepts. Finally, entrepreneurship tends to run in the family, with 48% of entrepreneurs raised in a family business, Prior experience—from formal education, previous work experience, and past failures—are all factors that contribute to entrepreneurial success. In addition to the task-specific traits mentioned above, an ability to maintain balance; "grit and gratitude," as Avi Savar phrases it in an Inc. article, is essential for long-term business and psychological health.

Exercise 8.3.2

You are an investor looking to buy in to a new start-up. You are about to meet with the startup's founder. Which of the following characteristics would indicate this person may NOT have what it takes to be a successful entrepreneur?

a. Creative thinker and resilient personality
b. Workaholic that follows orders without question.
c. Well-connected and goal-oriented
d. Charismatic leader with background in finance

Answer

b. Entrepreneurs do work hard, but they are usually the ones leading the charge and always thinking about how to do things better.

To the health point, it's worth noting that at the extreme, our strengths become our weaknesses or vulnerabilities. We see this most clearly in the Builder, but the downside risk is not limited to that personality type. In "The Psychological Price of Entrepreneurship," Jessica Bruder provides perspective on the emotional toll a startup business can take on an entrepreneur. This is not just a rite of passage; veteran entrepreneur Elon Musk publicly exhibited and discussed the "excruciating" personal toll Tesla has had on him in 2018 and his claims regarding privatization cost him his role as Tesla Chairman (he remains CEO).

Entrepreneurship can also have a steep financial toll: it's difficult (if not sometimes impossible) to maintain a separate job to pay the bills while working to create a new business. Any new venture will take up-front financial investment, and sometimes that

investment comes from the entrepreneur's own pocket rather than a third-party investor. However, if your idea pays off, the financial reward can make it worth it in the end.

learn more

Do you have what it takes to be an entrepreneur? Here are a few self-assessment options:

- Harvard Business Review's Should You Be an Entrepreneur? Test developed by Babson College Management Practice Professor Daniel Isenberg
- SBA's Small Business Readiness Assessment

If the assessments leave you undecided, consider one additional trait, drawn from Entrepreneur's "The 7 Traits of Successful Entrepreneurs" article: confidence. This is also a point made by LISNR Co-Founder & CEO Rodney Williams in his "So, You Want to Be An Entrepreneur?" article. His position: if you have to ask whether you're an entrepreneur, you're probably not. He refers to this as the "Miles Davis Test." Late in life, Davis was asked if he planned to continue making music. His response: I have to. I can't help it. That, according to Williams, captures "the soul of the entrepreneur."

Types of Entrepreneurs

How do we begin to understand entrepreneurship and entrepreneurs? Entrepreneurs can be categorized by a number of dimensions including the size and scalability of the business, the form of business, whether a business is home-based, brick & mortar or online and other dimensions.

It's tempting (and, quite frankly, comforting) to believe that a successful entrepreneurial game plan can be used by another entrepreneur with similar success. The problem with this logic is that it assumes that all entrepreneurs are essentially the same. Clearly, that's not the case. In working with a number of startups, "Entrepreneurial DNA" author Joe Abraham realized that although entrepreneurs share common traits, they have distinctly different personalities and to be successful, the strategy has to match the person. Abraham found that entrepreneurs exhibit one of four distinct types of "entrepreneurial DNA," each with its own strengths, weaknesses and characteristics. In presenting his concept in a TED Talk, Abraham proposed thinking of the DNA types as "presets on your radio." Each button is associated with a set of predisposed behaviors and decision-making matrix. And for each preset, there's a different path to market.

Abraham translated this insight into the BOSI Framework, with four entrepreneurial DNAs: Builder, Opportunist, Specialist, and Innovator.

Builders

A **builder** is, as one would expect, focused on scaling the business quickly. They tend to be serial entrepreneurs, perpetually building and selling businesses, often in completely unrelated industries. To a builder, success is measured in infrastructure terms—for example, office square footage and size of payroll. Builders tend to excel at attracting talent, investors and customers, but can exhibit a Dr. Jekyll and Mr. Hyde behavior that results in high turnover. As Abraham notes, "if you look back on their history, you see a wake of dead bodies: key employees, spouses, children."

Brothers Jeff and Rich Sloan are a good example of builders, having turned numerous improbable ideas into successful companies. Over the past 20-plus years, they have renovated houses, owned a horse breeding and marketing business, invented a device to prevent car batteries from dying, and so on. Their latest venture, a multimedia company called StartupNation, helps individuals realize their entrepreneurial dreams. And the brothers know what company they want to start next: yours.[1]

Opportunists

An **opportunist** measures success in financial terms and is always scanning for the next money-making opportunity. Opportunists tend to be impulsive decision makers—for better or worse.

Jeff Bezos recognized that with Internet technology he could compete with large chains of traditional book retailers. Bezos's goal was to build his company into a high-growth enterprise—and he chose a name that reflected his strategy: Amazon.com. Once his company succeeded in the book sector, Bezos applied his online retailing model to other product lines, from toys and house and garden items to tools, apparel, music, and services. In partnership with other retailers, Bezos is well on his way to making Amazon's vision "to be Earth's most customer-centric company; to build a place where people can come to find and discover anything they might want to buy online."—a reality.[2]

Specialists

Specialists are experts (e.g., accountants, doctors, lawyers) who generally spend their careers in one industry. They measure success based on their personal income. With an aversion to selling, their primary weakness is demand generation.

Sarah Levy loved her job as a restaurant pastry chef but not the low pay, high stress, and long hours of a commercial kitchen. So she found a new one—in her parents' home—and launched Sarah's Pastries and Candies.[3] In 2011, she rebranded her company as S. Levy Foods, expanding beyond her pastry focus. She now has five operating restaurants in airports across the United States where she seeks to bring "real food" to those traveling.[4]

Innovators

Innovators are the mad scientists of the world. They measure success based on impact; it's about the mission, not the money. Innovators are often accidental entrepreneurs; their weakness is business operations. They often start businesses just for personal satisfaction and the lifestyle. Miho Inagi is a good example of an innovator who built a company just for her personal satisfaction.

On a visit to New York with college friends in 1998, Inagi fell in love with the city's bagels. "I just didn't think anything like a bagel could taste so good," she said. Her passion for bagels led the young office assistant to quit her job and pursue her dream of one day opening her own bagel shop in Tokyo. Although her parents tried to talk her out of it, and bagels were virtually unknown in Japan, nothing deterred her. Other trips to New York followed, including an unpaid six-month apprenticeship at Ess-a-Bagel, where Inagi took orders, cleared trays, and swept floors. On weekends, owner Florence Wilpon let her make dough.

In August 2004, using $20,000 of her own savings and a $30,000 loan from her parents, Inagi finally opened tiny Maruichi Bagel. The timing was fortuitous, as Japan was about to experience a bagel boom. After a slow start, a favorable review on a local bagel website brought customers flocking for what are considered the best bagels in Tokyo. Inagi earns only about $2,300 a month after expenses, the same amount she was making as a company employee. "Before I opened this store I had no goals," she says, "but now I feel so satisfied."[5]

practice question 8.3.3

The author cites Joe Abraham's work classifying entrepreneurs by personality type, i.e. Builders, Opportunists, Specialists, and Innovators. Why would it be important for a entrepreneur to understand their entrepreneurial DNA?

a. To better work with your strengths and hire to cover for your weaknesses.
b. To better grasp the importance of your work
c. To better understand your competitors' strategies.
d. To better develop a business model for a targeted market

Answer

a. Knowing yourself is the key to being successful-leveraging your strengths and surrounding yourself with people who can compensate for your shortcomings.

To put faces on the labels, Donald Trump and Elon Musk are typical Builders, Virgin Group Founder Sir Richard Branson is a classic Opportunist, Bill Gates was a Specialist, and Mark Zuckerberg is an Innovator.

So why does the "type" of entrepreneur you are matter? Knowing yourself—your strengths and weaknesses—is key to selecting a business, assembling a team and developing a strategy that leverages your individual and collective (team's) entrepreneurial DNA. Specifically, it allows you to work with your strengths and hire to cover your weaknesses.

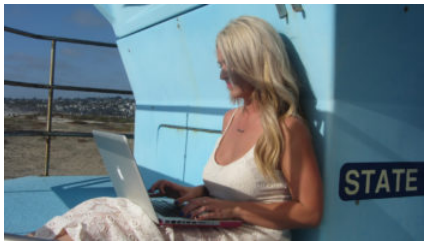
In an article for Entrepreneur, veteran startup mentor and angel investor Martin Zwilling recommends that every aspiring entrepreneur understand their DNA before they commit to a business venture. Indeed, he notes that investors and incubators have

adopted the use of formal assessments such as StrengthsFinder as part of their screening process.

learn more

To identify your entrepreneurial DNA type, take the free assessment at the BOSI DNA site: https://bosidna.com/.

Reasons to Be an Entrepreneur



As entrepreneurs often caution, being an entrepreneur is not a job, it's a lifestyle. Of course, that's precisely the attraction for many potential entrepreneurs. Life is more than a paycheck. Entrepreneurship is an alternative way of looking at the world and your place in it. For many, it's an opportunity to achieve their potential—a potential that may be limited or managed in a traditional job.

In an article for Entrepreneur, Uber Brands founder Jonathan Long cites 60 reasons to be an entrepreneur. Number 1 on his list: You have full control over your destiny. That's a particularly powerful motivator. Especially when you factor in the "at will" employment law (that is, you can be fired without cause), increased use of contingent labor (no benefits), gender and racial wage gaps and other predatory behaviors.

To the salary point, a woman earns on average 80.5 cents for every dollar a man earns. Breaking it down, the percentage of a white man's annual earnings by race is 87% for Asian women, 79% for white women, 63% for Black women and 54% for Hispanic women. A November 2017 World Economic Forum study projected that will take 100 years to close the gender pay gap. Further, instead of decreasing, the gap appears to be widening; the 2016 prediction was 86 years. What's particularly disturbing is what's been termed the "mommy penalty." A Senate Joint Economic Committee report found that women with children often earn less after returning to the workforce, while the opposite is true for working fathers. Key takeaway: if you're a woman and/or minority, the game is stacked against you. Perhaps it's time to take your marbles and start your own game with your own rules.

- The percentage of U.S. businesses with 1 to 50 employees owned by African Americans increased by 50% between 1996 and 2015.
- 19% of all companies with employees are owned by women.

Entrepreneurial motivation short-list:

1. Opportunity to make an impact.
2. Ability to live by your own rules, from values and culture to dress code, work environment and location.
3. Membership in an elite group of leaders and doers.
4. No bench time or waiting to be chosen
5. Opportunity based on performance rather than degrees
6. Relative freedom from discrimination
7. The thrill of creation and the ongoing challenges of growth
8. Unlimited upside (financial) potential; no growth ceilings
9. Extreme learning & personal growth
10. Working with stimulating people and emerging ideas/technologies
11. Recognition—after all, entrepreneurs are the rock stars of the business world.
12. Build something for future generations.
13. Defining "success" in your own terms.

Employment dynamics and dysfunctions aside, the key is to understand your values and priorities and decide whether the entrepreneurial lifestyle is a fit of you. For more on this point, read The Balance Careers article How to Use Self Assessment Tools to Help You Choose A Career.

The following short video is an example of the entrepreneurial spirit in action!

practice question 8.3.4

According to the author, what would be the most important reason to be an entrepreneur.

a. To be your own boss
b. To be idolized
c. To be among the elite
d. To be compensated well above the norm

Answer

a. The entrepreneur having control over their own destiny, cannot be fire "at will", and being relatively immune to discrimination is the top reason cited by the author to become an entrepreneur.

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8.4: Advantages, Disadvantages, and Considerations

What you'll learn to do: discuss the advantages, disadvantages, and important considerations of starting a small business

As author and retired entrepreneur Carol Denbow writes in Are Your Ready to Be Your Own Boss?, "If you want your new business to succeed, you must know why most businesses fail." New business survival statistics are grim. From 2005–2017, approximately 21% of new businesses failed in the first year. Roughly half of new business fail within 4 years. And only 33% of new businesses survive for 10 or more years. Why do you think that is? Denbow's next sentence provides a clue: "Most people spend more time planning their vacations than they do their new businesses." In this section, we'll discuss the pros and cons of starting a small business and, in particular, how to improve the odds of success.

Learning Objectives

- Explain why some business ventures fail
- List important considerations in deciding to start a business

Advantages and Disadvantages of Small-Business Ownership

There are very few things in life that can compare to the experience of creating your own business. As investor and former entrepreneur James Caan expresses it: "Nothing will ever replace the thrill of creating a profitable company from scratch."

Starting a small business is a matter of self-selection and self-determination. While the founders of small businesses still are a part of the society they live in, their business ventures can allow them to step into an alternate reality, part of a social order in which each person—regardless of gender, race, ethnicity, religion, birth or circumstances—can achieve their fullest potential and receive recognition for their achievements.

A small business owner has an extreme amount of latitude in both business and lifestyle choices, from developing the business concept and operating environment to defining success. The benefits—measured in impact, revenue, or infrastructure terms—are essentially unlimited. Perhaps the most nebulous, but important, benefit of being a small business owner is the freedom to choose your business's purpose and goals.

The flip side is that you own the decisions and the results of those decisions. Evasion is not an option: you can't say, "it's not my job," point fingers, shrug or check out. Additionally, as a small business owner, you will probably be risking your own (and, perhaps, friends & family) capital. Essentially, you're flying without a net. There's no guarantee of a regular paycheck and no paid or subsidized benefits (including a retirement plan, holidays, or perks). You're responsible for business development, business planning, HR, IT, and every other function as well.

Freedom from an employer's expectations comes at a cost: you're responsible for setting and managing expectations—for yourself and others—and for making the magic happen.

practice question 8.4.1

This section is a discussion of the advantages and disadvantages of starting a small business. According to the author, the underlying advantage to starting a small business is the freedom to make your own decisions regarding what the business is and what it does. But on the other side of the coin, the author reminds us that there is a price to pay- what is that price for the freedom from an employer's expectation?

a. The founder owns all of the responsibility for expectations and results.
b. The founder sets the hours of operation for the business.
c. The hounder is responsible for selecting employees
d. The founder must maintain accurate records

Answer

a. To be free of the expectations of an employer, the entrepreneur must accept the responsibility of self-expectation, as well as, the results of the business venture

Why Some Ventures Fail

Denbow's point about the importance of planning is cited in virtually every list of causes of failure. Why is this so critical? Failure to do the research, analysis and financial projections that business planning entails makes a small business more vulnerable to the following common causes of failure:

- Inability to execute on the business concept
- Lack of or insufficient market demand
- Lack of product or service (competitive) differentiation & other marketing issues (the four Ps of marketing)
- Lack of awareness of and/or ability to respond to emerging trends, relevant developments (technology, regulatory, geo-political, environmental) and competitive actions
- Overdependence on a single customer
- Inability to manage growth
- Inadequate cash reserves or failure to effectively manage cash flows. Related point: inadequate cash controls or personal/business separation, including using business revenue as a personal slush fund
- Insufficient management experience or product/services expertise
- Lack of self-awareness and related personal/professional development
- An inability to acknowledge weakness and/or compensate for skill and expertise gaps

One of the most critical risk factors is the founder's attitude and self-awareness, including the ability to objectively assess his or her management skills (or accept external feedback on this point), recruit to address skill and expertise gaps and effectively delegate responsibilities.

Statistics aside, it's important to understand that failure isn't final. The upside of failure is experience, a factor that contributes to success. Thus, the phrase "fail forward." As Mike Maddock notes in his take-off on this concept: "the most inventive people are usually the best at failing forward, i.e., learning from what went wrong."

practice question 8.4.2

What are the underlying factors of the causes for small business failure?

a. Government regulation
b. Economic recession
c. Failure to do the research, analysis and financial projections and the founder's attitude and self-awareness
d. Failure to attract the right business partners

Answer

c. According to the author, these are the most critical factors contributing to the various causes of small business failure.

Considerations When Starting a Business

The three fundamental questions to consider when deciding to start a business are:

1. Do you have what it takes?
2. Do you have a viable concept?
3. Is the reason you want to start a business consistent with your character and concept?

Yourself

Do you have what it takes?

The entrepreneurial assessments discussed earlier this module are a good starting point for self-assessment. Additionally, you might want to take the Grit Test developed by psychology professor and researcher Angela Duckworth.

Another way to approach the question is to review the type of questions a founder might ask in an interview and consider whether you would hire yourself. For perspective, scan the questions —and thought process behind the questions—shared by startup leaders and others in Firstround.com's The Best Interview Questions We've Ever Published. According to Anne Dwane, one of the serial entrepreneurs interviewed, "the most important quality any start-up leader (current or aspiring) can have is adaptability." To get at that, she asks (and you might want to ask yourself – and reflect on your responses) the following questions:

- What have you started?
- How would you describe yourself in your own words?
- How would a colleague describe you in three adjectives?
- What current trends are you seeing in your profession? (Substitute your target industry/market for your profession)
- What new things have you tried recently?

Additional questions to consider include Koru co-founder and CEO Kristen Hamilton's questions regarding grit, rigor, impact and ownership.

Your Concept

Do you have a viable concept?

Viability is something that will come out of the business planning process, which we will discuss in the next few sections. Before you dive into a business, it's essential to do careful planning to ensure that the venture has potential to succeed. Jumping in with no information and no plan is a recipe for disaster.

Your Business

Is the reason you want to start a business consistent with your character and concept?

The third consideration is doing a reality check on why you want to start a business. Consider Dwane's opening question: "what motivates you and what do you want to do next?" Can you connect the dots? Starting a new small business will require a lot of time and energy—if you're not truly passionate about your venture, especially when it's new, it (and you!) won't be able to stand up to the stress of day-to-day business.

practice question 8.4.3

Besides the importance of self-assessment (does the founder have what it takes) and matching the venture with the founder's character (is the business consistent with what the founder wants to do), what is the third most-important element in deciding to start a small business?

a. Conducting a self-interview
b. Conducting a customer survey
c. Conducting a business planning process to create a viable concept
d. Conducting a reality check

Answer

c. Besides the characteristics of the entrepreneur's personality and make up, conducting a rigorous planning process is vital to an informed decision to start a small business

Starting a business

Starting a business doesn't have to be an all or nothing proposition. A number of successful entrepreneurs developed their business concepts while in school or working a traditional job. In his "The Surprising Habits of Original Thinkers" TED Talk, Organizational psychologist, professor and author Adam Grant discusses the mistake he made in passing on an opportunity to one of his student's start-ups. He assumed that because the founders were working internships while developing the concept and had lined up jobs as a Plan B, they didn't have the commitment to make the business a success.

The business the students launched: Warby Parker, a glasses e-tailer that Fast Company named as the world's most innovative company in 2016. Warby Parker is currently valued at $1.75 million. For additional perspective, read Jason DeMers The Pros and Cons of Starting a Business While Working A Full-Time Job for Entrepreneur.

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8.5: Steps on Starting a Business

What you'll learn to do: describe the steps to starting a business

In this section, we move from introspection and the nature of entrepreneurship to the specific steps involved in starting a business. Reducing the process to a list of steps is deceptive; it can take from a month to a year to get started and the work involved will test both your grit and your rigor. As Walt Disney said: "The way to get started is to quit talking and begin doing."

Learning Objectives

- Briefly describe the steps to starting a business

Ten Steps to Starting a Business

The SBA's 10 Step Guide to Starting a Small Business includes the following action items, with links to the associated detail page.

1. Conduct market research
2. Write your business plan
3. Fund your business
4. Pick your business location
5. Choose a business structure
6. Choose your business name
7. Register your business
8. Obtain federal and state tax IDs
9. Apply for state licenses and permits
10. Open a business bank account

The IRS site is the source of federal action items, including requesting employer IDs and accessing tax forms and publications. Direct link to the IRS Small Business and Self-Employed portal: https://www.irs.gov/businesses/small-businesses-self-employed. For state-specific guidelines, you can use the IRS' State Government Websites page as a jumping off point or use a search phrase such as "starting a business in [state]." Your city or county may have additional requirements; refer to the relevant site for any permit or licensing requirements.

The nonprofit small business education and mentoring organization SCORE is another source of start-up information including a Simple Steps for Starting Your Business workbook, online course and additional resources and webinars. Finally, your city or county may have an economic development program that provides business planning expertise, relevant economic data and access to funding.

practice question 8.5.1

According to the SBA, the following are steps needed to start a business EXCEPT:

a. Fund your business
b. Choose your business name
c. Register with the Chamber of Commerce
d. Open a business bank account

Answer

c. This is not one of the 10 steps although it is probably something a new business owner would want to do at some point.

Understanding the Steps for Starting a Business

In this section, we'll discuss each of the 10 start-up steps briefly, so you understand the flow and see the connections between the individual action items.

Step 1: Conduct Market Research

As Peri Pakroo notes in The Women's Small Business Start-Up Kit (an excellent resource regardless of your gender), "Before you launch any business—even before you write a business plan—you'll need to gather information and do research to demonstrate that your idea will be successful." The key insight is that doing research first allows you to test drive and fine tune—or reject, if necessary—your business concept, reducing the risk of your new venture.

SBA's Conduct Market Research page recommends two areas of research: market and competitive. You'll use market research to understand consumer behavior and market and economic factors. Competitive research will inform your business offering and positioning relative to the existing product or service providers in your market.

Step 2: Write Your Business Plan

We'll drill down into business plans in the next section. Interim perspective: Your business plan distills your research and analysis into an actionable plan, including your unique value proposition, competitive strategy and what it will take—in specific operating and financial statement terms—to succeed.

Step 3: Fund Your Business

There's a range of options for funding your business: self-financing, microloans, crowdfunding (see Fundly's top 40 ranking), regional development or government grants and loans, business competition awards and venture capital. What's important to note is that a businesses start-up costs (developed in the business plan) and choice of funding have implications for the business structure and business ownership/management.

Step 4: Pick Your Business Location

Selecting a business location depends on a range of factors including your type of business, proximity to your target market, business partners, economic development support, suppliers and your personal preferences. In addition, you will need to factor in taxes, zoning laws and other fees and regulations relevant to your business operation.

Step 5: Choose A Business Structure

As the SBA site notes: "The business structure you choose influences everything from day-to-day operations, to taxes, to how much of your personal assets are at risk. You should choose a business structure that gives you the right balance of legal protections and benefits." The table below summarizes the options and liability and tax implications.

	Business structure	Ownership	Liability	Taxes
ıre	**Sole proprietorship**	One person	Unlimited personal liability	Personal tax only
ıre	**Partnerships**	Two or more people	Unlimited personal liability unless structured as a limited partnership	Self-employment tax (except for limited partners) Personal tax
ıre	**Limited liability company (LLC)**	One or more people	Owners are not personally liable	Self-employment tax Personal tax or corporate tax
ıre	**Corporation – C corp**	One or more people	Owners are not personally liable	Corporate tax
ıre	**Corporation – S corp**	One or more people, but no more than 100, and all must be U.S. citizens	Owners are not personally liable	Personal tax
ıre	**Corporation – B corp**	One or more people	Owners are not personally liable	Corporate tax
ıre	**Corporation – Nonprofit**	One or more people	Owners are not personally liable	Tax-exempt, but corporate profits can't be distributed

Note as well that the business structures entail different levels of administrative paperwork and cost of incorporation. For example, the cost of a sole proprietorship is generally just the cost of registering a "DBA" or Doing Business As (also referred to as a trade name, fictitious name if you're not conducting business in your own name; incorporating requires extensive record-keeping, operational processes and reporting as well as higher registration or filing fees. If you're particularly focused on social impact and/or sustainability, you may want to explore structuring as a Benefit Corporation, Certified B Corp or "L3C," low-profit limited liability company structures.

Step 6: Choose Your Business Name

Choosing a business name is an opportunity to communicate not only what you do but who you are: the personality and your unique value proposition. You may want to create multiple options and test drive your short list with people who represent your target audience. Also consider how your name will look in print and using the type of signage and advertising you plan to use. Prior to committing to a name, check domain name and DNA registrations to make sure the name is available and use a trademark search tool such as the U.S. Patent and Trademark Office's trademark search tool to avoid infringement.

Depending on your business, your social media presence may be your website, so be sure to claim and manager your business identity on relevant rating sites such as Yelp, TripAdvisor. One way to monitor your business reviews is to set up a Google Alert on your business name.

Step 7: Register Your Business

Business registration requirements are based on business structure and location. As the SBA site notes:

- Entity name protects you at state level
- Trademark protects you at a federal level
- Doing Business As (DBA) doesn't give legal protection, but might be legally required
- Domain name protects your business website address

To the DBA point: A duplicate name will generally not be approved. Prior to filing, conduct a DBA search to verify that the name you want to use is not already in use. At a local If you're conducting business using your legal name (versus a DBA), there is generally no registration required.

Step 8: Obtain Federal and State Tax IDs

The downstream effect of income is taxes. Enter federal and state tax IDs. At a minimum, you will need an Employer Identification Number (EIN) or federal tax ID number, with the potential exception of sole proprietors. For elaboration on that point, refer to the When does a sole proprietor need a EIN? Discussion on the NOLO site. In addition to paying federal taxes, you will need an EIN to hire employees, open a business bank account and apply for business licenses and permits. To determine whether you need a state tax ID, use the state lookup function on the SBA site and research from there.

Step 10: Open A Business Bank Account

The SBA advises new business owners to open a business bank account as soon as they start accepting or spending money as a business. Doing so avoids one of the risk factor the commingling of personal and business assets cited as a failure risk factor in the prior section. Business author and coach Peri Pakroo also cautions against running your business out of your personal account, citing two specific reasons:

1. If you created an LLC or a corporation to protect your personal assets, commingling business and transactions undermines that protection.
2. If combining business and personal transactions will make it much more difficult to do essential financial management tasks.

You may want to read a few Best Banks for Small Business articles to evaluate the options. SmartAsset's Best Banks for Small Business (2018) analysis is one of a number of analyses.

practice question 8.5.2

Besides gathering information for your new business, the most significant benefit of conducting market research is:

a. understanding how many employees will be needed to staff your business.
b. test driving and fine-tuning your business concept to demonstrate that it will be a success.
c. choosing the best location for your new business.
d. outlining your marketing strategy given your target customer.

Answer

b. Doing the research first allows you to validate your business idea and reduce the risk of failure

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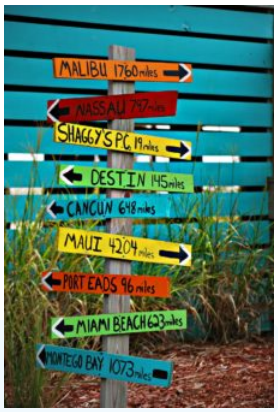
8.6: Business Plans

What you'll learn to do: list and describe the key components of a business plan



Personal time author Alan Lakein sets the stage for this section with this quote: "Planning is bringing the future into the present so that you can do something about it now."

Business planning forces an entrepreneur to develop a detailed understanding of the market—including their unique value proposition, competitive strategy, and what it will take to succeed. This understanding includes specific operating and financial statement terms, which often take a significant amount of research and time to discover.

In this section, we will focus in on the business plan, which pulls together the research, analysis and self-assessment of prior sections.

Learning Objectives

- Briefly describe the components of a business plan

Create Your Business Plan

The SBA recommends prospective entrepreneurs address the following nine elements in their business plan:

1. Executive Summary
2. Company Description
3. Market Analysis
4. Organization & Management
5. Service or Product Line
6. Marketing & Sales
7. Funding Request
8. Financial Projections
9. Appendix

The SBA provides two example business plans for reference: consulting firm and toy manufacturer.

Note that the length and depth of business plans vary depending on the audience and objective. For example, a business owner(s) seeking a traditional bank loan will likely need a more detailed plan. An alternative is the lean business plan, which PaloAlto Software and BPlan founder and CEO Tim Berry claims can be completed in an hour. The process and timeframe is probably more applicable to a seasoned entrepreneur, but it may be worth reading Berry's Fundamentals of Lean Business Planning blog post to see if it's a fit. There are a number of one page business plan templates freely available online; to view a range of options, conduct an image search on "one page business plan template." A final approach for consideration is venture capitalist Guy Kawasaki's 10/20/30 formula: 10 slides, 20 minutes, 30 point font. In those 10 slides, Kawasaki recommends eliminating pitch-speak and focusing on the topics that matter to a VC:

1. Problem
2. Your solution
3. Business model
4. Underlying magic/technology
5. Marketing and sales
6. Competition
7. Team
8. Projections and milestones
9. Status and timeline
10. Summary and call to action

practice question 8.6.1

The SBA recommends that a business plan addresses the following major elements EXCEPT:

a. Funding request
b. Company description
c. Market analysis
d. IT analysis

Answer

D. Correct. IT strategy is not a major element addressed in a business plan.

Understanding the Components of Business Plans

Although terminology and formats differ, most business plans include the same key ingredients. Let's drill down into the elements SBA recommends:

Executive Summary

Briefly summarize what you do (Product or Service) for whom (Target Market) and what will make you successful. Elements to include: mission statement, management and organizational structure highlights, intended location and scale of operation. If you're seeking financing, include summary-level financial information and growth projections.

Company Description

In this section, provide a more detailed description of your company, including the opportunity (aka market problem addressed) and your solution. Be specific in identifying your target market, including a description of the consumer profile or list of target businesses or organizations. This is where detail your competitive advantage, including management expertise and/or product, process, or other differentiators.

Market Analysis

This is where the rigor of your research pays off. Use this section to summarize your understanding of the economy, industry, your target market and related trends and developments. This is also where you would incorporate competitive research, including success factors and what your positioning and value proposition will be relative to competitors. For perspective on competitive mapping, see the links to sample analyses below:

- Business News Daily.com: Porter's Five Forces: Analyzing the Competition
- Simplicable's 3 Examples of a Competitive Map
- Harvard Business Review's Mapping Your Competitive Position

Organization & Management

In this section, describe your legal structure (e.g., sole proprietor, partnership, corporation) and introduce yourself and management team or advisors, if applicable. You may also want to elaborate on any related points or motivations such as a social impact or sustainability orientation. If applicable, include an organizational chart so readers can visualize who's in charge of what functions.

You may also want to include key accomplishments to illustrate what specific expertise each person brings to the team. Key management resumes can be included in the Appendix.

Service or Product Line

Use the product or service section to detail your offerings and any market differentiators such as copyrights or patents. Explain what benefit your product or service delivers to your customers, in particular relative to competitive offerings. If applicable, highlight quality and/or process or material supply certifications and any other points that influence purchase decisions or reduce business risk.

cliff bar

Cliff Bar is a case study in using sustainability as a business strategy and competitive differentiator. For perspective, read UC Davis' Clif Bar: Raises the Bar on Sustainability write-up of Clif

Bar President and Chief Operating Officer Kevin Cleary's Dean's Distinguished Speaker presentation. Research and development activities and any related funding should also be detailed in this section.

Marketing & Sales

In a world where consumers are overwhelmed by choices, you can't expect a better product or service to win on merit alone. Your task in this section is to describe your plan to bring your product or service to market. You should also detail how the sales will happen so related costs and technology can be factored into your financials. The complexity of your marketing activities and sales process (and corresponding sales lead time) will depend on your product or service.

learn more

For a general perspective, see Fitsmallbusiness.com's Sales Funnel Templates, Definition & Stages article. The approach that works for you will depend on your business and your nature. The good news is technology has made a range of low cost options available.

For a dose of marketing perspective and creative inspiration, read Creative Guerilla Marketing's What is Guerilla Marketing article.

Funding Request (if applicable)

If you're using your business plan to request funding, this section is where you'll detail your funding requirements and the intended use of those funds over the next five years. The SBA recommends specifying whether you're asking for debt or equity financing and your desired terms, including interest rate and time period. Provide an explanation of the funding need—for example, to cover operating expenses while building a revenue pipeline. Finally, state your future strategic plan, whether it's paying off debt or selling the business.

Financial Projections

A business plan is nothing without numbers and financial statements should be prepared regardless of whether you're requesting funding or using your business plan as proof of concept. Projections should cover a five year period and include a financial outlook summary as well as forecasted income statements, balance sheets, cash flow statements and capital expenditure budgets.

The SBA advises using more detailed (quarterly or monthly) projections for the first year. This level of detail also serves as a reality check and early warning for you as a business manager as you implement your plan. If your business is an ongoing concern, include actual income statements, balance sheets, and cash flow statements for the last three to five years. If you have other assets you're prepared to offer as collateral, list them in this section. Review your projections and funding request details to make sure the narrative and numbers are in synch. This section runs the risk of becoming a blur of numbers without significance. Be thoughtful and creative (with your design, not the numbers) in order to present your financials in a clear and compelling manner.

Appendix

The Appendix is used to provide supporting detail and provide any other relevant or requested documentation. The SBA lists the following common items to include: credit histories, resumes, product pictures, letters of reference, licenses, permits, or patents, legal documents, permits, and other contracts.

Resources

SBA's Business Plan Tool (registration required)

practice question 8.6.2

In the components of a business plan, what section contains a detailed description of the company, the problem/opportunity, proposed solution to be offered, and your competitive advantage?

a. Market analysis
b. Service and Product Line

c. Company description
d. Organization and Management

Answer

c. The Company description offers a detailed view of those factors.

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8.7: Putting It Together- Entrepreneurship

We began this module by considering the contributions of entrepreneurs not only to the economy but to our daily lives. Reflecting on what you have learned in this module, think for a moment about how far entrepreneurs have taken us, our economy, and the world. From two brothers who owned a bicycle shop in Dayton, Ohio . . .

. . . to this:

Summary

Entrepreneurs are the rockstars of the business world. However, as entrepreneur and venture capitalist Mark Suster notes, being an entrepreneur is only sexy for those who aren't entrepreneurs. The reality is "it's gritty, tough work where you will be filled with self-doubt. Entrepreneurs are survivors." In a Forbes interview, serial entrepreneur and Dopple Cofounder Chao Wang echoed that sentiment, noting that behind the social media scenes – what interviewer and fellow entrepreneur Carrie Kerpen terms "hustlebrags" – "is the unglamourous nuts and bolts of building a company." The flip side is that working for someone else can also be gritty, tough work – without the ownership upside (or glory).

Many people consider working for someone else – the "guarantee" of a weekly or biweekly paycheck – as the less risky option. Risk is relative. During the last ("Great") recession, officially from December 2007 to June 2009 – financial institutions and automotive manufacturers were bailed out but 8.7 million people lost their jobs, approximately eight million homes were foreclosed on, 2.5 million businesses closed, food insecurity spiked and income inequality grew to a level not seen since the Great Depression. Perhaps the most significant statistic: 95% percent of the gains from economic recovery since 2009 have gone to the

top 1% of earners. On the risk point, legendary investor and Berkshire Hathaway chairman and CEO Warren Buffet comments: If you think being an entrepreneur is risky, try working for someone else for 40 years and living off social security."

There's an essential difference between someone who is looking for a job and someone who wants to start a business. Entrepreneurship isn't so much a choice as a compulsion. LISNR CEO and Cofounder Rodney Williams cites "sheer ambition" as his driver, a desire to test his grit and a belief that he could "do something great….So I did." For those who are flirting with the idea of entrepreneurship, there are a multitude of assessments and articles on the best time or place or age to become an entrepreneur (a few links below). All good perspective, but trying to time an entrepreneurial bid is a bit like trying to time the market. The only things that have proven to improve the odds of a successful start-up are planning – specifically, developing a business plan that reflects economic, personal and marketing realities – and experience. To the latter point, Wang mentions in her interview that she had originally considered attending business school but found "actually building companies was so much more educational and gratifying." Her closing advice: "Just get started – it's never the perfect time. It's always going to feel scary. And detach your sense of accomplishment, happiness, and self-worth from how productive you are, or how fast your company is growing, or whatever OKRs or KPIs that seem hugely important. I've always placed high importance on loving the process—I'm excited by the day-to-day challenges versus just finding happiness in reaching the milestones."

https://www.forbes.com/sites/martinz.../#3137a35e4bd1

https://www.entrepreneur.com/slideshow/307581

www.inc.com/carmine-gallo/ne...r-twenties.htm

Additional Resources:

The Small Business Administration Web site has a wealth of resources for starting entrepreneurial ventures in the U.S.

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CHAPTER OVERVIEW

9: Management

9.1: Why It Matters- Management
9.2: Manager
9.3: Management Theory
9.4: Planning
9.5: Organizing
9.6: Leading
9.7: Controlling
9.8: Putting It Together- Management

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9.1: Why It Matters- Management

Why describe the primary functions, responsibilities, and skills of effective leadership and management?

You go out for dinner to your favorite restaurant for a special occasion—let's say graduation. It took a month or more to save up the money, and your date/spouse bought a new outfit just for this outing. Maybe, if you have children, you splurged and got a babysitter for the entire evening. Whatever the circumstances, you have planned an evening to remember. As the night progresses, things are not turning out as you hoped. The hostess has no record of your reservation, so there's a delay. When your waiter finally appears, he's grouchy and unhelpful. You place your order and anxiously await what Yelp* describes as a "5-star dining experience." By the time your food comes, you have devoured the bread on your table, a pack of mints rummaged from your purse, and you're eying the leftovers on the neighboring table. When your steak finally arrives, it's overcooked and sits beside a heap of steamed broccoli instead of the baked potato you ordered. You hate broccoli. So, who do you call?

No, not Ghostbusters! You want to speak to the *manager*, because the manager has the responsibility and authority to resolve the problem (or at least try). But managers do more than just listen to customers complain. As you will discover in this section, whether they interact with customers, employees, suppliers, contractors or the general public, managers and leaders play an important, multidimensional role in all business organizations.

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9.2: Manager

Learning Objectives

- Describe technical skills in relation to management
- Describe human skills in relation to management

Managerial Levels

Being a successful manager can seem like a juggling act—keeping many balls in the air while keeping one's composure.

All industries need management, and the managers who perform that function need to possess certain skills. Before we talk about those skills, though, it's important to understand that the title of manager actually refers to three distinct groups of people within an organization: top-level or executive managers, middle managers, and first-line managers. Each level has a different area of managerial responsibility and reporting structure.

Top Managers

These are the highest level of managers within an organization, and they are tasked with setting organizational objectives and goals. These managers scan the external environment for opportunities, help develop long-range plans and make critical decisions that affect the entire organization. They represent the smallest percentage of the management team. Many times these managers have titles such as chief executive, operations manager, or general manager.

Middle Managers

Mid-level or middle managers allocate resources to achieve the goals and objectives set by top managers. Their primary role is to oversee front-line managers and report back to top-level managers about the progress, problems, or needs of the first-line managers. Middle managers span the distance between production operations and organizational vision. While top managers set the organization's goals, middle managers identify and implement the activities that will help the organization achieve its goals.

First-Line Managers

The primary responsibility of first-line managers is to coordinate the activities that have been developed by the middle managers. These managers are responsible for supervising non-managerial employees who are engaged in the tasks and activities developed by middle managers. They report back to middle managers on the progress, problems, or needs of the non-managerial employees. These managers are on the front lines, so to speak, where they are actively involved in the day-to-day operations of the business.

Figure 9.2.1: The management pyrimid

Managerial Skills

The skills needed to succeed at each level of management vary somewhat, but there are certain skills common to all. Robert Katz identifies three critical skill sets for successful management professionals: **technical skills, conceptual skills, and human skills**.

While these three broad skill categories encompass a wide spectrum of capabilities, each category represents a useful way of highlighting the key capabilities and their impact on management at different levels.

Technical Skills

Of the three skill sets identified by Katz, technical skills are the broadest, most easily defined category. A **technical skill** is defined as a learned capacity in just about any given field of work, study, or even play. For example, the quarterback of a football team must know how to plant his feet and how to position his arm for accuracy and distance when he throws—both are technical skills. A mechanic, meanwhile, needs to be able to take apart and rebuild an engine, operate various machinery (lifts, computer-scanning equipment, etc.), and know how to install a muffler, for example.

Managers also need a broad range of technical abilities. Front-line managers, in particular, often need to use technical skills on a daily basis. They need to communicate up the chain of command while still speaking the language of the workers who are executing the hands-on aspects of the industry. A technical skill for a front-line manager might include a working understanding of a piece of equipment: the manager must be able to coach the employee on its operation, but also be able to explain the basic functions of the machinery to upper managers. Managers in other corporate roles and at higher levels also require technical skills. These can include office-based competencies such as typing, programming, Web-site maintenance, writing, giving presentations, and using software such as Microsoft Office or Adobe.

Conceptual Skills

Conceptual skills are also crucial to managerial success. **Conceptual skills** enable one to generate ideas creatively and intuitively and also show comprehensive understanding of contexts or topics. Conceptual skills tend to be most relevant to upper-level thinking and broad strategic situations (as opposed to lower-level and line management). As a result, conceptual skills are often viewed as critical success factors for upper-managerial functions.

The key to this type of skill is **conceptual thinking**. Although conceptual thinking is difficult to define, it is generally considered to be the ability to formulate ideas or mental abstractions. When combined with information and a measure of creativity, conceptual thinking can result in new ideas, unique strategies, and innovative solutions. While all levels of management benefit from conceptual thinking, upper management spends the most time with this mindset, since it is largely tasked with identifying and drafting a strategy for the broader operational and competitive approach of an organization. Because this kind of strategic planning includes generating organizational values, policies, mission statements, ethics, procedures, and objectives, upper managers need to possess strong conceptual skills.

While upper management may use the conceptual skill set most, middle managers and front-line managers must also both understand and participate in the company objectives and values. Of particular importance is the ability to communicate these critical concepts to subordinates and decide which information to convey to upper management.

Tracking and collecting the results of conceptual thinking are parts of a feedback loop. Conceptual skills are important in empowering managers in all levels of an organization to observe the operations of an organization and frame them conceptually as an aspect of that organization's strategy, objectives, and policies. Conceptual thinking allows for accurate and timely feedback and organizational adaptability.

Human Skills

The development of human skills— a combination of social, interpersonal, and leadership skills—is central to the success of any manager.

Over the years, the conventional definition of management has become less specific, as managerial functions can include staffing, directing, and reporting. Modern companies have fewer layers of management, as these companies now tend to delegate (rather than concentrate) responsibilities and authority to achieve goals. As a result, businesses often expect managers to lead or guide people, rather than giving out instructions for every action or task. The ability to lead people is therefore a central component of human skills.

Realistically, most organizations need managers who can view their teams analytically and objectively, evaluate inefficiencies, and make unpopular choices. However, it's misguided to think that a manager has to be distant from or disliked by subordinates to execute these responsibilities. Creating a healthy work environment that's conducive to development, constructive criticism, and achievement simply requires strong human skills—especially in the realm of communication.

Good managers understand not only what they are trying to say but also the broader context and implications of saying it. A sender communicating a message to a receiver is not simply transmitting factual information. Other dimensions of the exchange are just as important: empathy, self-reflection, situational awareness, and charisma all play integral roles in communicating effectively and positively.

In sum, technical, conceptual, and human skills are all needed to be an effective manager. As a manager moves up the organizational ladder, he or she may find that success requires fewer or different technical skills and a heavier reliance on interpersonal and human skills.

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9.3: Management Theory

What you'll learn to do: summarize the development of management theory and the key functions of management today

Management theory got its start during the Industrial Revolution when companies were interested in maximizing the productivity and efficiency of their workers in a scientific way. In this section you'll learn about the major contributors to the field of management theory and how their ideas are used today.

Learning Objectives

- Summarize the contributions of Frank and Lillian Gibreth to scientific management
- Summarize Henri Fayol's contributions to the field of management theory
- Summarize the key functions of management today

Scientific Management Theory

Just over one hundred years ago Frederick Taylor published *Principles of Scientific Management*, a work that forever changed the way organizations view their workers and their organization. At the time of Taylor's publication, managers believed that workers were lazy and worked slowly and inefficiently in order to protect their jobs. Taylor identified a revolutionary solution:

> *The remedy for this inefficiency lies in systematic management, rather than in searching for some unusual or extraordinary man.*

You might think that a century-old theory wouldn't have any application in today's fast-paced, technology-driven world. You'd be wrong, though! In fact much of what you've already learned in this course is based on Taylor's work, and plenty of what you'll experience in the workplace will be indebted to him, too. If you recognize any of the following, you have already seen his principles of scientific management in action: organizational charts, performance evaluations, quality measurements and metrics, and sales and/or production goals.

Scientific management is a management theory that analyzes work flows to improve economic efficiency, especially labor productivity. This management theory, developed by Frederick Winslow Taylor, was popular in the 1880s and 1890s in U.S. manufacturing industries.

While the terms "scientific management" and "Taylorism" are often treated as synonymous, a more accurate view is that Taylorism is the first form of scientific management. Taylorism is sometimes called the "classical perspective," meaning that it is still observed for its influence but no longer practiced exclusively. Scientific management was best known from 1910 to 1920, but in the 1920s, competing management theories and methods emerged, rendering scientific management largely obsolete by the 1930s. However, many of the themes of scientific management are still seen in industrial engineering and management today.

Frederick Winslow Taylor

Frederick Winslow Taylor is considered the creator of scientific management.

Frederick Winslow Taylor was an American mechanical engineer who sought to improve industrial efficiency by determining the amount of time it takes workers to complete a specific task and determining ways to decrease this amount of time by eliminating any potential waste in the workers' process.

A significant part of Taylorism was time studies. Taylor was concerned with reducing process time and worked with factory managers on scientific time studies. At its most basic level, time studies involve breaking down each job into component parts, timing each element, and rearranging the parts into the most efficient method of working. By counting and calculating, Taylor sought to transform management into a set of calculated and written techniques..

Taylor proposed a "neat, understandable world in the factory, an organization of men whose acts would be planned, coordinated, and controlled under continuous expert direction. " Factory production was to become a matter of efficient and scientific management—the planning and administration of workers and machines alike as components of one big machine.

One of Taylor's most famous studies was from his time at the Bethlehem Steel Corporation in the early 1900's. He noticed that workers used the same shovel for all materials, even though the various materials differed in weight. By observing the movements of the workers and breaking the movements down into their component elements, Taylor determined that the most efficient shovel

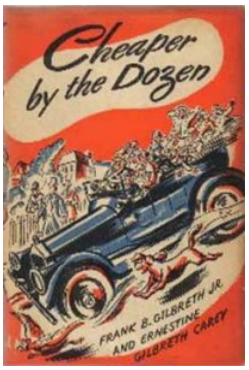
load was 21½ lb. Accordingly, he set about finding or designing different shovels to be used for each material that would scoop up that amount.

Taylor summed up his efficiency techniques in his 1911 book *The Principles of Scientific Management.* Important components of scientific management include analysis, synthesis, logic, rationality, empiricism, work ethic, efficiency, elimination of waste, and standardized best practices. All of these components focus on the efficiency of the worker and not on any specific behavioral qualities or variations among workers.

Taylor's scientific management consisted of four principles:

1. Replace rule-of-thumb work methods with methods based on a scientific study of the tasks.
2. Scientifically select, train, and develop each employee rather than passively leaving them to train themselves.
3. Provide detailed instruction and supervision of each worker in the performance of that worker's discrete task.
4. Divide work nearly equally between managers and workers, so that the managers apply scientific management principles to planning the work and the workers actually perform the tasks.

Frank and Lillian Gilbreth



Cheaper by the Dozen

While Taylor was conducting his time studies, Frank and Lillian Gilbreth were completing their own work in motion studies to further scientific management. The Gilbreth name may be familiar to anyone who has read the book *Cheaper By The Dozen*, a biographical novel about the Gilbreth family, their twelve children, and the often humorous attempts of the Gilbreths to apply their efficiency methods in their own household.

The Gilbreths made use of scientific insights to develop a study method based on the analysis of work motions, consisting in part of filming the details of a worker's activities while recording the time it took to complete those activities. The films helped to create a visual record of how work was completed, and emphasized areas for improvement. Secondly, the films also served the purpose of training workers about the best way to perform their work.

This method allowed the Gilbreths to build on the best elements of the work flows and create a standardized best practice. Time and motion studies are used together to achieve rational and reasonable results and find the best practice for implementing new work methods. While Taylor's work is often associated with that of the Gilbreths, there is a clear philosophical divide between the two scientific-management theories. Taylor was focused on reducing process time, while the Gilbreths tried to make the overall process more efficient by reducing the motions involved. They saw their approach as more concerned with workers' welfare than Taylorism, in which workers were less relevant than profit. This difference led to a personal rift between Taylor and the Gilbreths, which, after Taylor's death, turned into a feud between the Gilbreths and Taylor's followers.

Even though scientific management was pioneered in the early 1900s, it continued to make significant contributions to management theory throughout the rest of the twentieth century. With the advancement of statistical methods used in scientific management, quality assurance and quality control began in the 1920s and 1930s. During the 1940s and 1950s, scientific management evolved into operations management, operations research, and management cybernetics. In the 1980s, total quality management became widely popular, and in the 1990s "re-engineering" became increasingly popular. One could validly argue that Taylorism laid the groundwork for these large and influential fields that we still practice today.

Field of Management Theory

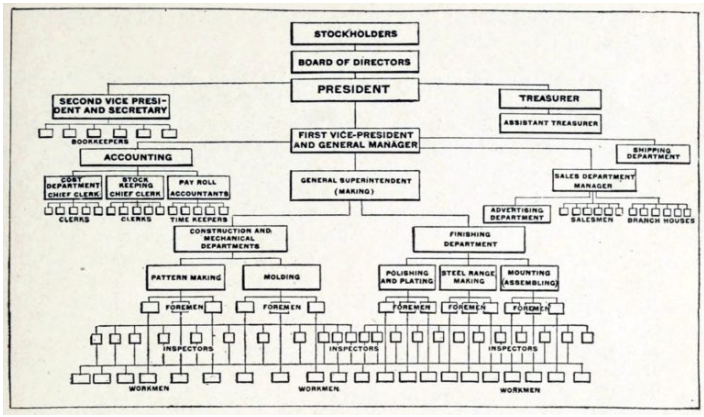
Henri Fayol, ca. 1900

Managers in the early 1900s had very few resources at their disposal to study or systematize their management practices. Henri Fayol, who was a French mining engineer and author, saw the need for this kind of study and, using the mines as the basis for his studies, developed what is now regarded as the foundation of modern management theory. In 1914 he published *Administration industrielle et générale*, which included his now-famous "fourteen principles of management." Fayol's practical list of principles guided early twentieth-century managers to efficiently organize and interact with employees.

Fayol recognized that management is fundamentally a process involving people. He saw that work could be managed more efficiently and smoothly by supporting the workers doing the tasks. He proposed that if managers could instill a sense of team spirit (esprit de corps) and encourage employees to contribute their own ideas, the problem of high turnover and instability in the workforce might be solved. At the time, working conditions in much of the industrialized world were terrible, and many of Fayol's

principles ran counter to conventional ways of thinking about and treating workers. For instance, Fayol said that it's essential to pay a fair wage for a fair day's labor, and he claimed that productivity would actually increase if managers treated workers fairly and kindly. These were radical ideas at the time. Fayol argued that that discipline, while important to organizational success, ought to come from effective leadership—not from dictatorial or harsh management practices. Fayol recognized that a company's people, not its structure, determine success or failure.

Fayol also addressed the role of structure in building an efficient organization. Several of his management principles deal with the framework in which managers operate, touching on aspects of what we would today call "organizational structure." He encouraged companies to arrange men, machines, and materials systematically in order to maximize efficiency. In short, he applied the adage "a place for everything and everything in its place" to the operations of a business. He believed that managers ought to communicate to employees about their roles and responsibilities in a clear and compelling manner, thereby reducing uncertainty and waste. He also brought to the business environment a concept that had been used in military strategy for centuries: the chain of command. Fayol's "scalar chain" was, in effect, an organization chart of the type seen today (and below), showing the lines of communication and chain of command from the top of a company to the bottom. He believed that by means of such hierarchies, firms could achieve unity of direction and command.



Organization Chart of a Large Stove-Manufacturing Company, 1914.

The notion of unity of direction and command meant that "for any action whatsoever an employee should receive orders from one superior only," a concept Fayol adapted from the biblical teaching that "no man can serve two masters." He proposed that organizational activities having the same objective should be directed by a single manager using a unified plan to attain a single common goal. At the same time, that single manager oversees one group of workers all working together to reach the goal. By adhering to these principles of unity, organizations can avoid duplicating efforts and realize efficiencies instead.

These efficiencies were not possible without what Fayol established as his first and perhaps most profound principle—the division of labor or division of work. Fayol recommended that jobs be broken down to the individual tasks that comprise the whole and workers be assigned to those individual tasks or series of tasks. He believed that when someone performs the same task over and over, he acquires speed and accuracy. Fayol observed: "The worker always on the same post, the manager always concerned with the same matters, acquires an ability, sureness, and accuracy which increases their output."[1]

Fayol also made an enormous contribution to management theory through his scientific study of the work of management. He made a clear distinction between operational activities—manufacturing, sales, etc.—and managerial activities, which he viewed as being fundamentally concerned with human interaction. From there, he systematically examined the different aspects of the management process and spelled out the functions that managers perform.

In the following excerpt from *General and Industrial Management*, Fayol identifies five functions of management:

> *"To manage is to forecast and **plan**, to **organize**, to **command**, to **coordinate**, and to **control**. To foresee and provide means examining the future and drawing up the plan of action. To organize means building up the dual structure, material and human, of the undertaking. To command means maintaining activity among the personnel. To coordinate*

> *means binding together, unifying, and harmonizing all activity and effort. To control means seeing that everything occurs in conformity with established rule and expressed command. [Emphasis added.]*[2]"

Over the years, management theorists have built upon and refined Fayol's original work and, more recently, have combined the "command" and "coordinate" functions into one function: leading. Today, the key functions of management are considered to be the following: **planning, organizing, leading**, and **controlling**. All levels of management perform these functions; however, as with the skills required for effective management, the amount of time a manager spends on each function depends on the level of management and the needs of the organization. In the next readings we will explore each of these functions in greater depth.

1. Fayol, H. (1949). General and Industrial Management (C. Storrs, Trans.). London: Sir Isaac Pitman & Sons. ↵
2. Fayol, H. (1949). General and Industrial Management (C. Storrs, Trans.). London: Sir Isaac Pitman & Sons. ↵

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9.4: Planning

What you'll learn to do: identify the types of planning and decision making managers engage in, and explain how these help organizations reach their goals

Managers engage in many different types of planning. In this section you'll learn about the differences between strategic, tactical, operational, and contingency plans and how these plans relate to organizational goals.

Learning Objectives

- Explain the components of a SWOT analysis
- Explain how planning helps organizations reach their goals

Planning

Planning is a process of thinking about and organizing the activities needed to achieve a desired goal. By now you are familiar with the most encompassing of all organizational planning: the business plan. The business plan provides the foundation for ongoing planning activities, but as the business grows and develops, it's the manager's responsibility to make adjustments and take the plans to the next level. A business without solid strategic, operational, and contingency plans will have a hard time meeting its organizational goals—unless it intends to survive by luck alone.

The Foundation of Planning

When managers begin to plan, they need to plan based on something – an idea, an opportunity or a dream. The company vision and mission statements create the foundation for planning by summarizing a company's business strategy in a form that can be communicated and understood easily by stakeholders.

- **Vision Statement:** A vision statement gives employees something to rally behind, and for those businesses that choose to make their vision statement public, it lets the world know where the company is going. Ikea, the Swedish multinational group of companies that designs and sells ready-to-assemble furniture, is driven by its corporate vision. This is the IKEA vision: "To create a better everyday life for the many people."
- **Mission Statement**: A mission statement outlines how the business will turn its vision into reality and becomes the foundation for establishing specific goals and objectives. Ikea's mission is "to offer a wide range of well-designed, functional home furnishing products at prices so low that as many people as possible will be able to afford them." It is this mission that will enable them to realize the vision of "better everyday life."

Until a business has determined what its mission is, planning cannot begin. Furthermore, one plan cannot possibly encompass everything necessary to achieve the organization's mission, so managers are tasked with developing sets of plans that, together, guide the organization's activities.

Strategic Plans

Strategic plans translate the company mission into a set of long-term goals and short-term objectives. In the process of determining a company's strategic plan, top-level managers set out to answer the following questions:

1. Where are we now?
2. Where do we want to be?
3. How do we get there?

Tactical Plans

Tactical plans translate high-level strategic plans into specific plans for actions that need to be taken up and down the layers of an organization. They are short-range plans (usually spanning less than one year) that emphasize the current operations of various parts of the organization. As a company refines or alters its strategic plans, the tactics must also be adjusted to execute the strategy effectively. A tactical plan answers the following questions:

1. What is to be done?
2. Who is going to do it?
3. How is it to be done?

Operational Plans

Operational plans establish detailed standards that guide the implementation of tactical plans and establish the activities and budgets for each part of the organization. Operational plans may go so far as to set schedules and standards for the day-to-day operations of the business and name responsible supervisors, employees, or departments.

Contingency Plans

Unforeseen events or disasters can be especially harmful to a business. For example, a fire, earthquake, or flood can make it impossible to continue normal business operations. A contingency plan lays out the course of action a business will take in response to possible future events.

SWOT Analysis

One of the key planning tools managers have at their disposal is the situation analysis, or SWOT analysis. SWOT stands for *strengths*, *weaknesses*, *opportunities*, and *threats*. Conducting such an analysis provides a means of projecting expectations, anticipating problems, and guiding decision making. As shown in the graphic, below, a SWOT analysis is an examination of the internal and external factors that impact the organization and its plans.

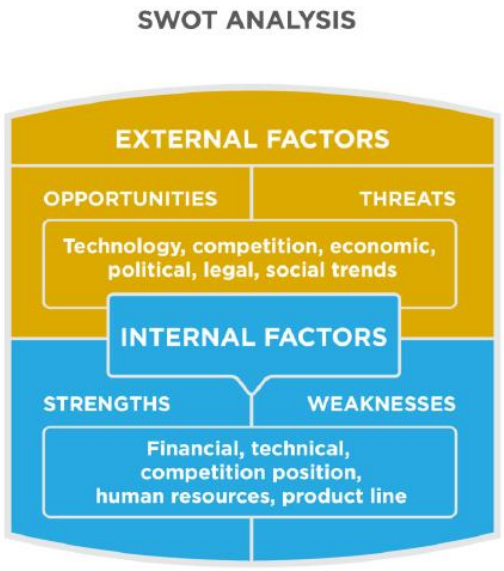

Figure 9.4.1: SWOT Analysis for external and internal factors

The external factors include opportunities and threats that are outside of the organization. These are factors that the company may be able influence—or at least anticipate—but not fully control. Examples of external factors are technology innovations and changes, competition, economic trends, government policies and regulations, legal judgments, and social trends.

The internal factors include strengths and weaknesses within the organization currently. Examples of internal factors are financial resources, technical resources and capabilities, human resources, and product lines. Since the company has the most control over internal factors, it can develop strategies and objectives to exploit strengths and address weaknesses.

The benefit of a SWOT analysis is that it gives a managers a clear picture of the “situation” in which it operates and helps them develop realistic plans. Managers must continually scan the internal and external business environment for signs of change that may require alterations to their plans. The organization’s strengths and weaknesses evolve over time, and new threats and opportunities can appear out of the blue. Ignoring signals that technology, consumer demands, resource availability or legal requirements are changing can leave the business in an inferior position relative to the competition and can very well mean the end of the business. For this reason, effective managers should use SWOT analysis as a tool to inform decision making and planning on a regular basis.

You can see how pervasive planning is within a business and that plans can run the gamut from the broad and general (as with the strategic plan, for example) to the narrow and specific (as with operational plans), but each type of plan is important to the overall success of an organization. Furthermore, planning is crucial to fulfilling the other functions of management. Without plans,

effective organizing, leading, and controlling won't happen. Failure to plan—or postponing it—can be a real liability for labor-oriented, hands-on managers.

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9.5: Organizing

What you'll learn to do: describe the organizing function of management and common types of organizational structure

Organizing is a critical part of executing a plan, and it's a critical part of being a manager. In this section you'll learn what organizing entails and the different types of organizational structures that businesses can use.

Learning Objectives

- Differentiate between divisional, functional, and matrix structures

Organizing

Once a plan has been created, a manager can begin to organize. Organizing involves assigning tasks, grouping tasks into departments, delegating authority, and allocating resources across the organization. During the organizing process, managers coordinate employees, resources, policies, and procedures to facilitate the goals identified in the plan. Organizing is highly complex and often involves a systematic review of human resources, finances, and priorities.

Before a plan can be implemented, managers must organize the assets of the business to execute the plan efficiently and effectively. Understanding specialization and the division of work is key to this effort, since many of the "assets" are employees. Recall what Henri Fayol wrote about the division of work:

> *"The specialization of the workforce according to the skills of a person, creating specific personal and professional development within the labour force and therefore increasing productivity, leads to specialization which increases the efficiency of labour. By separating a small part of work, the workers speed and accuracy in its performance increases. This principle is applicable to both technical as well as managerial work.[1]"*

Where workers are specialists, managers can group those employees into departments so their work is appropriately directed and coordinated. In short, work should be divided, and the right people should be given the right jobs to reduce redundancy and inefficiency.

Benefits of Organizing

While the planning function of managers is essential to reaching business goals, lots of careful planning can go to waste if managers fail to organize the company's assets and resources adequately. Some of the benefits of organizing include the following:

- Organization harmonizes employees' individual goals with the overall objectives of the firm. If employees are working without regard for the big picture, then the organization loses the cohesion necessary to work as a unit.
- A good organizational structure is essential for the expansion of business activities. Because organizational structure improves tracking and accountability, that structure helps businesses determine the resources it needs to grow. Similarly, organization is essential for product diversification, such as the development of a new product line.
- Organization aids business efficiency and helps reduce waste. In order to maximize efficiency, some businesses centralize operations while others arrange operations with customer or regional demands in mind.
- A strong organizational structure makes "chain of command" clear so employees know whose directions they should follow. This in turn improves accountability, which is important when outcomes are measured and analyzed.

This is a short list of the benefits managers (and businesses) realize when they take the time to organize. When it comes to the particular organizational structure a business follows, a variety of factors, such as size, industry, and manager preference come into play.

Types of Organizational Structure

Organizations can be structured in various ways, with each structure determining the manner in which the organization operates and performs. An organization's structure is typically represented by an **organization chart** (often called simply an "org chart")—a diagram showing the interrelationships of its positions. This chart highlights the chain of command, or the authority relationships

among people working at different levels. It also shows the number of layers between the top and lowest managerial levels. Organizational structure also dictates the **span of control** or the number of subordinates a supervisor has. An organization with few layers has a wide span of control, with each manager overseeing a large number of subordinates; with a narrow span of control, only a limited number of subordinates reports to each manager. The structure of an organization determines how the organization will operate and perform.

Divisional Structure

One way of structuring an organization is by division. With this structure, each organizational function has its own division.

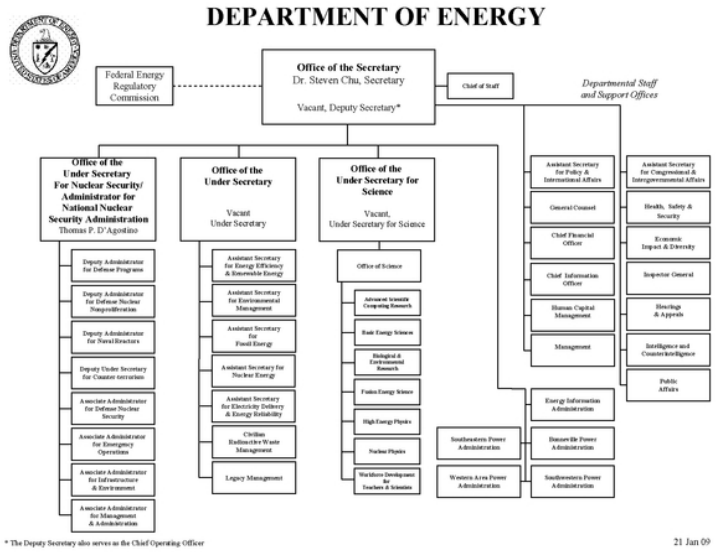

Figure 9.5.1: U.S. Department of Energy organization chart: The DOE organization chart shows a divisional structure with different divisions under each of three under-secretaries for energy. Each of the three division is in charge of a different set of tasks: environmental responsibilities, nuclear-energy responsibilities, or research responsibilities.

Each division can correspond to products or geographies of the organization. Each division contains all the necessary resources and functions within it to support that particular product line or geography (for example, its own finance, IT, and marketing departments). Product and geographic divisional structures may be characterized as follows:

- **Product departmentalization:** A divisional structure organized by product departmentalization means that the various activities related to the product or service are under the authority of one manager. If the company builds luxury sedans and SUVs, for example, the SUV division will have its own sales, engineering, and marketing departments, which are separate from the departments within the luxury sedan division.
- **Geographic departmentalization:** Geographic departmentalization involves grouping activities based on geography, such as an Asia/Pacific or Latin American division. Geographic departmentalization is particularly important if tastes and brand responses differ across regions, as it allows for flexibility in product offerings and marketing strategies (an approach known as localization).

Functional Structure

In a **functional structure**, a common configuration, an organization is divided into smaller groups by areas of specialty (such as IT, finance, operations, and marketing). Some refer to these functional areas as “silos”—entities that are vertical and disconnected from one another. Accordingly, the company’s top management team typically consists of several functional heads (such as the chief financial officer and the chief operating officer). Communication generally occurs within each functional department and is transmitted across departments through the department heads.

Functional departments are said to offer greater operational efficiency because employees with shared skills and knowledge are grouped together according to the work they do. Each group of specialists can therefore operate independently, with management acting as the point of cross-communication between functional areas. This arrangement allows for increased specialization.

One disadvantage of this structure is that the different functional groups may not communicate with one another, which can potentially decrease flexibility and innovation within the business. Functional structures may also be susceptible to tunnel vision, with each function seeing the organization only from within the frame of its own operation. Recent efforts to counteract these tendencies include using teams that cross traditional departmental lines and promoting cross-functional communication.

Functional structures appear in a variety of organizations across many industries. They may be most effective within large corporations that produce relatively homogeneous goods. Smaller companies that require more adaptability and innovation may feel confined by the communication and creativity silos that result from functional structures.

Matrix Structure

The **matrix structure** is a type of organizational structure in which individuals are grouped by two different operational perspectives at the same time; this structure has both advantages and disadvantages but is generally best employed by companies large enough to justify the increased complexity.

In a matrix structure, the company is organized by both product and function. Product lines are managed horizontally and functions are managed vertically. This means that each function—e.g., research, production, sales, and finance—has separate internal divisions for each product. In matrix organizations, the company is grouped by the perspectives it deems most appropriate. Common organizational perspectives include function and product, function and region, or region and product. In an organization grouped by function and product, for example, each product line will have management that corresponds to each function. If the organization has three functions and three products, the matrix structure will have nine (3×3) potential managerial interactions. This example illustrates how inherently complex matrix structures are compared to other, more linear structures.

Proponents of matrix management argue that this structure allows team members to share information more readily across task boundaries, which addresses the silo problem of functional management. Matrix structures also allow for specialization, which can increase depth of knowledge and and enable individuals to be assigned according to project needs.

A disadvantage of the matrix structure is the increased complexity in the chain of command when employees are assigned to both functional and project managers. This arrangement can result in a higher manager-to-worker ratio, which, in turn, can increase costs or lead to conflicting employee loyalties. It can also create a gridlock in decision making if a manager on one end of the matrix disagrees with another manager. Blurred authority in a matrix structure can hamper decision making and conflict resolution.

Matrix structures should generally only be used when the operational complexity of the organization warrants it. A company that operates in various regions with various products may require interaction between product development teams and geographic marketing specialists—suggesting a matrix may be beneficial. Larger companies with a need for a great deal of cross-departmental communication generally benefit the most from this model.

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1. Fayol, H. (1949). General and Industrial Management (C. Storrs, Trans.). London: Sir Isaac Pitman & Sons ↵

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9.6: Leading

What you'll learn to do: describe common management and leadership styles, and identify the circumstances under which they are most effective

In this section you'll learn about common management and leadership styles and when they're most effective.

Learning Objectives

- Identify the circumstances under which different management styles are effective
- Differentiate between transformational, transactional, and narcissistic leadership styles

Different Management Styles

Regardless of their position within an organization, managers need to act as leaders. Some people think leadership means guiding others to complete a particular task, while others believe it means motivating the members of your team to be their best selves. Whatever the differences in emphasis or wording, the following is probably a fair definition: Leaders are people who know how to achieve goals and inspire people along the way.[1] In a business setting, leadership also means being able to share a clear vision of where the company is heading while providing the knowledge, information, and methods needed to get there.

A manager can take a number of different approaches to leading and overseeing an organization. A manager's style of giving direction, setting strategy, and motivating people is the result of his or her personality, values, training, and experience. Let's examine some of the most common management styles and the circumstances under which each is most appropriate.

Management Styles

Autocratic/Authoritarian

Under an autocratic management style, decision-making power is concentrated in the manager. Autocratic managers don't entertain any suggestions or consider initiatives from subordinates. This style of management is effective for quick decision making but is generally not successful in fostering employee engagement or maintaining worker satisfaction. When do managers tend to use this style?

- In crisis situations, when it's impractical to solicit employee input, managers may become autocratic. For example, a manager might order employees to vacate the building because of fire or another emergency. Taking the time to seek advice or opinions is not only impractical but could endanger lives.
- Traditionally, if the workforce is comprised of low-skill workers, employee input isn't encouraged because it's considered to be of limited value or importance. However, more forward-thinking managers regard all worker input as valuable, regardless of skill level.

Laissez-Faire/Free-Rein

The laissez-faire style is sometimes described as "hands-off" management because the manager delegates the tasks to the followers while providing little or no direction. If the laissez-faire manager withdraws too much, it can sometimes result in a lack of productivity, cohesion, and satisfaction. Under this type of management, subordinates are given a free hand in deciding their own policies and methods.When do managers employ this approach?

- When workers have the skills to work independently, are self-motivated, and are held accountable for results (physicians are a good example), laissez-faire management may be effective. Highly skilled employees require less frequent instruction, and managers must rely on them to use their professional expertise to make sound decisions.
- Managers of creative or innovative employees often adopt this approach in order to foster creativity. For example, computer programmers, artists, or graphic designers can benefit from a hands-off management style. Managers step out of the way to make room for new ideas, creative problem-solving, and collaboration.

Participative/Democratic

Under a participative or democratic style of management, the manager shares the decision-making authority with group members. This approach values individual interests and perspectives while also contributing to team cohesion. Participative management can help employees feel more invested in decisions, outcomes, or the choices they've made, because they have a say in them. When is this an appropriate managerial choice?

- When an organization enters a transitional period—a merger or acquisition, expanding into a new market, closing a facility, or adding new products, for example—managers need to guide the workforce through the change. Such circumstances involve adjustments and adaptations for a large group of people, so managers may find that a participative management style is most effective.
- Businesses often encounter new or unexpected challenges. During tough times, resourceful managers will solicit input from employees at many levels within the organization. A democratic approach can uncover people with invaluable experience, advice, and solutions.

Each style of management can be effective if matched with the needs of the situation and used by a skilled, versatile manager. The best managers are adept at several styles and able to exercise good judgement about which one is suited to the task at hand.

Leadership in Management

There was a time when the role of a manager and a leader could be separated. A foreman in a shoe factory during the early 1900s didn't give much thought to what he was producing or to the people who were producing it. His or her job was to follow orders given to him by a superior, organize the work, assign the right people to the tasks, coordinate the results, and ensure the job got done as ordered. The focus was on efficiency.

In the new economy, however, where value increasingly comes from knowledge—as opposed to skill—and where workers are no longer undifferentiated cogs in an industrial machine, management and leadership are not easily separated. People look to their managers not just to assign them a task but to articulate a purpose, too. Managers are expected to organize workers not just as a means of maximizing efficiency but to nurture abilities, develop talent, and inspire results.

The late management guru Peter Drucker was one of the first to recognize this shift in the roles and relationships of managers and employees. He identified the emergence of the "knowledge worker" and the profound impact that would have on the way business is organized. With the rise of the knowledge worker, "one does not 'manage' people," Drucker wrote. "The task is to lead people. And the goal is to make productive the specific strengths and knowledge of every individual."[2]

With Drucker's idea of "leading people" in mind, let's examine the types of leaders most commonly encountered in business. Keep in mind that the management styles described above are not separate from leadership, but rather are another dimension to the manager as an individual. Managers don't put on an autocratic manager hat one day and a transformational leader hat the next. Instead, every individual fulfilling a managerial role within an organization must be able to adapt his or her style to the situation at hand. This adds considerable complexity to the role of a manager and is one of the reasons that a manager may leave a company—it just wasn't a good "fit." A poor fit may be the result of a tug-of-war between management styles, personality, and leadership qualities.

Different Leadership Styles

Transformational

Transformational leaders work with subordinates to identify needed change, create and share an inspiring vision, and bring about change together with committed members of a group. Transformational leadership serves to enhance the motivation, morale, and job performance of followers through a variety of mechanisms. These include connecting the follower's sense of identity and self to a project and to the collective identity of the organization; being a role model for followers in order to inspire them and to raise their interest in the project; challenging followers to take greater ownership for their work; and understanding the strengths and weaknesses of followers, allowing the leader to align followers with tasks that enhance their performance. Transformational leaders are often idealized and viewed as moral exemplars for their contributions to a team, an organization, or a community.

Transactional

Transactional leadership was first described by Max Weber in 1947 and later by Bernard Bass in 1981. This kind of leadership, also known as managerial leadership, focuses on supervision, organization, and performance. Unlike transformational leaders, those using the transactional approach are not looking to change the future—they value the status quo. Transactional leaders pay attention to their followers' work in order to find fault or deviation and gain their compliance through a system of rewards and punishments.

There are two factors that form the basis for this reward/punishment system: contingent reward and management by exception. Contingent reward provides rewards (material or psychological) for effort and recognizes good performance. Management by exception allows the leader to maintain the status quo; the leader intervenes when subordinates do not meet acceptable performance levels and initiates corrective action to improve performance.

Narcissistic

Narcissistic leaders are known for being interested only in themselves, at the expense of others, such as employees or group members. The leader's narcissism may be healthy or destructive, although there is a continuum in between. To critics, the narcissistic leader—especially one with destructive narcissism—is driven by unyielding arrogance, self-absorption, and a personal egotistic need for power and admiration. A study published in *Personality and Social Psychology Bulletin* suggests that when a group is without a leader, a narcissist often takes charge; researchers found that people who score high in narcissism tend to take control of leaderless groups. Freud considered "the narcissistic type . . . especially suited to act as a support for others, to take on the role of leaders and to . . . impress others as being 'personalities'."

In reality, leaders come in as many flavors as ice cream. There are many more types than the three described above. Some leaders are directing; others are more relaxed—acting more like a coach than a boss. Leaders might not lead with the same style all the time, either. There are occasions when managers must take a firm stand, making critical decisions on their own, and other times when they work with their employees to build a consensus before acting. Each style has its place and time, and each manager has his or her own preferred approach. Consider the CEO of Japan Airlines profiled in the following video and what his actions say about his management and leadership style.

1. http://www.businessnewsdaily.com/364...efinition.html ↵
2. http://guides.wsj.com/management/developing-a-leadership-style/what-is-the-difference-between-management-and-leadership/ ↵

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9.7: Controlling

What you'll learn to do: explain why control is an essential part of effective management, and outline the steps of the control process

In this section you'll learn about the control function of management and become familiar with the steps of the control process.

Learning Objectives

- Explain what SMART objectives are
- Outline the steps of the control process

Controlling

What Is Control?

Figure 9.7.1. Parking lot control

Consider the two images in Figure 9.7.1. . . . one with control and one without. Think of the two parking lots as two different organizations. What you can see is that one has management controls in place, and the other . . . well, you can tell how that's working out. In the second photo no one is in charge of controlling the actions and activities of the employees within the company—it's a free-for-all.

It might seem attractive, at first, to work for a company where people aren't telling you what to do, how to do it, or when things are due. But it wouldn't take too long, probably, for all that freedom to feel like chaos. In this next section we'll focus on the control function of management to better understand how it helps people and organizations achieve goals and objectives.

In business or management context, control is the activity of observing a given organizational process, measuring performance against a previously established metric, and improving it where possible. Organizations are made up of operational processes and systems, each of which can be iterated upon and optimized. At the upper-managerial level, control revolves around setting strategic objectives for the short and long term, as well as measuring overall organizational success. Developing methods for optimizing operational processes is often done at the mid-managerial level. The mid-level manager measures success within his or her span of control—which could be a division, a region, or a particular product. The line manager is then responsible for controlling the actions of the workers to ensure that activities are carried out in a way that optimizes outcomes and outputs. He or she will measure the success of individual workers, work teams, or even a shift. What managers up and down the organizational chart have in common is that they all use the same process for carrying out the control function of management.

The process of control usually consists of the following four parts:

1. setting standards,
2. measuring performance against those standards,
3. analyzing performance, and
4. taking corrective action.

Take special note of the language that we use when we talk about the control function—*process*! Controlling the activities within an organization is a continuous process that resembles navigation. In order to reach a destination, a ship navigator sets a course and then constantly checks the headings—if the ship has drifted off course, the navigator makes the necessary corrections. This cycle of check-and-correct, check-and-correct happens over and over to keep the ship on course and get it to where it's going. Similarly, the controlling function in business is a process of repeatedly checking and correcting until standards and objectives are met.

Another feature of the control process is that it's designed to be proactive. The idea is for managers to intervene before costly or damaging problems occur, rather than waiting and hoping for the best. It's better to take corrective action when you're drifting off course than try to salvage your ship after you've crashed into a rock. The benefit to managers and organizations of a forward-looking, proactive approach is that it reduces customer complaints, employee frustration, and waste.

Setting Standards and Objectives

Organizational standards and objectives are important elements in any plan because they guide managerial decision making. Performance standards and objectives may be stated in monetary terms—such as revenue, costs, or profits—but they may also be set in other terms, such as units produced, number of defective products, levels of quality, or degree of customer satisfaction.

Peter Drucker suggests that operational objectives should be SMART, which means specific, measurable, achievable, realistic, and time constrained: [1]

- An operational objective should be **specific**, focused, well defined, and clear enough that employees know what is expected. A specific objective should identify the expected actions and outcomes. This helps employees stay on track and work toward appropriate goals.
- An operational objective should be **measurable** and quantifiable so people can assess whether it has been met or not. For example, "increase annual sales revenue by 10 percent" is a measurable objective.
- An objective needs to be **achievable**. It's important for all the stakeholders—especially the employees doing the work—to agree that the objective can be met. Unachievable objectives can be damaging to employee trust and morale.
- An objective should be **realistic** as well as ambitious. It should take into account the available resources and time.
- Lastly, an objective should be **time constrained**. Having a deadline can help increase productivity and prevent the work from dragging on.

It's important to get employee input during the process of developing operational objectives, as it may be challenging for employees to understand or accept them after they're set. After determining appropriate operational objectives for each department, plans can be made to achieve them.

Measuring Performance

Performance measurement is the process of collecting, analyzing, and/or reporting information regarding the performance of an individual, group, organization, system, or component. The ways in which managers and organizations measure performance vary greatly—there is no single systemic approach that fits all companies or conditions. The most important element of measuring performance is to do them at regular intervals and/or when particular milestones are reached. The best processes for measuring performance provide information in time for day-to-day decisions.

The rubric for measuring organizational performance is called a **performance metric**. These metrics measure an organization's behavior, activities, and performance. In order to be effective, the metric should relate to a range of stakeholder needs, including those of customers, shareholders, and employees. Metrics may be finance based or they may focus on some other measure of performance, such as customer service or customer perceptions of product value. For example, in call centers, performance metrics help capture internal productivity and the quality of service. Typical metrics might be calls answered, calls abandoned, average service time, and average wait time.

In general, performance metrics usually involves the following:

1. Establishing critical processes/customer requirements
2. Identifying specific, quantifiable outputs of work
3. Establishing targets against which results can be scored

Analyzing Performance

Once performance has been measured, managers must analyze the results and evaluate whether objectives have been met, efficiencies achieved, or goals obtained. The means by which performance is analyzed vary among organizations; however, one tool that has gained widespread adoption is the **balanced scorecard.** A balanced scorecard is a semi-standardized strategic management tool used to analyze and improve key performance indicators within an organization. The original design of this balanced scorecard has evolved over the last couple decades and now includes a number of other variables—mostly where performance intersects with corporate strategy. Corporate strategic objectives were added to allow for a more comprehensive strategic planning exercise. Today, this second-generation balanced scorecard is often referred to as a "strategy map," but the conventional "balanced scorecard" is still used to refer to anything consistent with a pictographic strategic management tool.

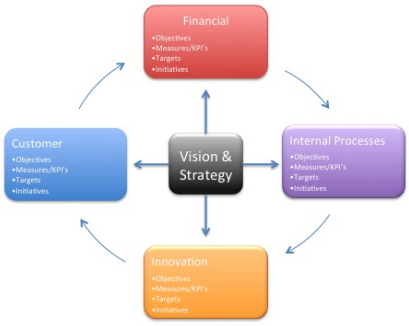

Figure 9.7.2. The balanced scorecard: On a standard balanced scorecard, each "perspective" reminds the user to articulate attributes necessary for an effective scorecard: the financial perspective, the customer's perspective, innovation, and internal processes, all of which come together to form an organization's vision and strategy.

The following four perspectives are represented in a balanced scorecard:

1. **Financial**: includes measures focused on the question "How do we look to shareholders?"
2. **Customer**: includes measures focused on the question "How do customers perceive us?"
3. **Internal business processes**: includes measures focused on the question "What must we excel at?"
4. **Learning and growth**: includes measures focused on the question "How can we continue to improve and create value?"

Managers generally use this tool to identify areas of the organization that need better alignment and control vis-à-vis the broader organizational vision and strategy. The balanced scorecard brings each of an organization's moving parts into one view in order to improve synergy and continuity between functional areas.

Taking Corrective Action

Once the cause of nonperformance or underperformance has been identified, managers can take corrective action. **Corrective action** is essentially a planned response aimed at fixing a problem. At this stage of the controlling process, problem-solving is key.

The first step managers must take is to accurately identify the problem, which can sometimes be hard to distinguish from its symptoms or effects. Collecting information and measuring each process carefully are important prerequisites to pinpointing the problem and taking the proper corrective action. Attempts at corrective action are often unsuccessful because of failures in the problem-solving process, such as not having enough information to isolate the real problem, or the presence of a manager or decision maker who has a stake in the process and doesn't want to admit that his department made a mistake. Another reason why the problem-solving process can run aground is if the manager or decision maker was nevery properly trained to analyze a problem.

Once the problem is identified, and a method of corrective action is determined, it needs to be implemented as quickly as possible. A map of checkpoints and deadlines, assigned to individuals in a clear and concise manner, facilitates prompt implementation. In many ways, this part of the control process is very much a process itself. Its steps can vary greatly depending on the issue being addressed, but in all cases it should be clear how the corrective actions will lead to the desired results.

Next, it's important to schedule a review and evaluation of the solution. This way, if the corrective action doesn't bring the desired results, further action can be taken swiftly—before the organization falls even further behind in meeting its goals. Organizations may also decide to discuss a problem and potential solutions with stakeholders. It's useful to have some contingency plans in place, as employees, customers, or vendors may have unique perspectives on the problem. Gaining a broader view can sometimes help management arrive at a more effective solution.

A manager must use a wide range of skills to navigate the management process well. This journey begins with sound planning, based on a set of SMART goals and objectives. The manager leads both people and processes, using a blend of leadership and management styles appropriate to the situation. If the manager has done a good job of placing the right people in the right places, and has implemented sound standards and performance metrics, then she is well-positioned to take corrective action where needed. Regardless of whether the task is to get a customer's order assembled and shipped on time or expand into a new market, the functions of the manager remain unchanged.

1. https://en.Wikipedia.org/wiki/Operational_objective#3._Factors_that_affect_operational_objectives_of_an_organization ↵

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9.8: Putting It Together- Management

Synthesis

Ship captains, jugglers, parking lots . . . Why have we used so many different analogies to describe managers and management? Because all of them are appropriate given the diversity of roles and responsibilities that managers have on any given day. They must truly possess a broad range of skills in order to react, adapt, plan, and change course swiftly to stay ahead of changes inside and outside of the organization. Perhaps the best way to sum it up is that managers and leaders need to be prepared because . . .

Summary

Managers

Managers wear many hats and must bring with them an entire toolkit of skills—ranging from interpersonal to technical skills—in order to reach organizational goals and objectives effectively. Without the proper skill set, managers can find themselves unable to gain the trust and support of those around them, making their job more difficult and, in some cases, impossible.

Management Theory

Although the world of business has changed tremendously over time, the four functions of management—planning, organizing, leading, and controlling—originally identified by Fayol in the early 1900s still hold. What has changed is where and how managers perform these four primary functions.

Planning

Planning within a business ranges from the big picture to the very granular, from the organization's foundational plan (its mission) and set of strategic plans to its daily operations plans. Each one builds upon the other, and without a well-developed set of plans that management can implement, an organization will likely drift from one venture or problem to another without ever really achieving success.

Organizing

The structure of an organization can have a tremendous impact on the organization's ability to react to both internal and external forces. Organizational structure also determines the managers' span of control, communication channels, and operational responsibilities. The organization should be structured in such a way that it reflects the company's mission and supports its customer and product/services goals to the greatest advantage.

Leading

From autocratic to laissez-faire, leadership styles run the entire spectrum. Some of the most effective leaders are those who can adopt different styles to fit the situation at hand.

Controlling

The control function of management has two aims: to make order out of chaos and to evaluate whether the company's efforts and resources are being maximized. Remember that the "control function" doesn't give management license to be manipulative or autocratic. Instead it refers to the importance of control through *evaluation*, since evaluation is the key to knowing whether a company is producing the desired results or not.

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CHAPTER OVERVIEW

10: Motivating Employees

10.1: Why It Matters- Motivating Employees
10.2: The Hawthorne Effect
10.3: 10.3 Need-Based Theories
10.4: Process-Based Theories
10.5: Theory X, Theory Y, and Theory Z
10.6: Strategies for Motivating Employees
10.7: Putting It Together- Motivating Employees

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10.1: Why It Matters- Motivating Employees

Why explain common motivational theories and apply them to business?

What motivates you to do what you do? How do you motivate others to help you or to accomplish things on their own? You have already learned a lot about business and the role people play, both as managers and employees, in helping the organization reach its goals. As a manager you are expected to lead and manage people. As an employee you are given job specific duties and responsibilities you are expected to perform. Neither leading nor following will happen until people are motivated.

The following video on the motivational strategies used by Zappos is a good place to begin our discussion of motivation in business. What motivates the employees at Zappos? Is it high salaries? Long vacations? The chance to shave your head at the company picnic once a year? As you watch the video, pay attention to what really motivates Zappos workers.

Since the 1920s researchers have studied human behavior and developed a variety of theories to explain the driving force behind motivation. These theories range from the need to provide a safe and secure environment for oneself and family to the compelling desire *not* to experience negative consequences from action or inaction. Understanding the basis for motivation and learning how motivational approaches work in the business environment can be helpful to your professional and organizational success.

Before you begin this module ask yourself the following questions:

- What motivates me?
- How have others tried to motivate me?
- Which motivational approaches have been the most and least successful?
- When have I been successful in motivating others?
- How can I use this information to be successful in my personal and professional life?

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10.2: The Hawthorne Effect

What you'll learn to do: describe the Hawthorne effect, and explain its significance in management

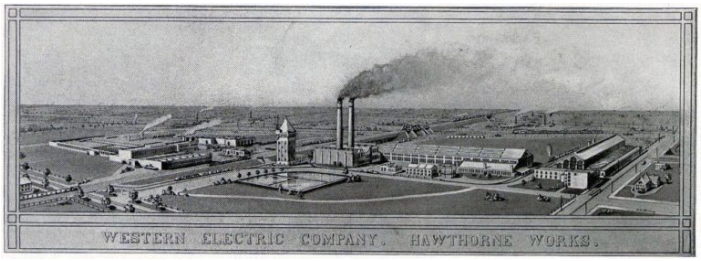
Many of today's ideas about the connection between human motivation and employee performance can be traced back to the discoveries of the Hawthorne studies.

Learning Objectives

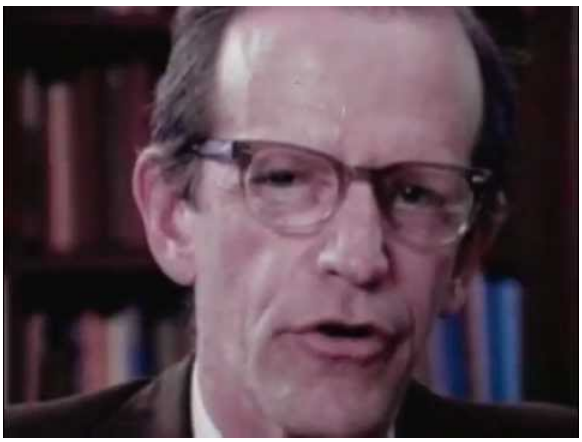
- Explain the role of the Hawthorne effect in management

The Hawthorne Studies

During the 1920s, a series of studies that marked a change in the direction of motivational and managerial theory was conducted by Elton Mayo on workers at the Hawthorne plant of the Western Electric Company in Illinois. Previous studies, in particular Frederick Taylor's work, took a "man as machine" view and focused on ways of improving individual performance. Hawthorne, however, set the individual in a social context, arguing that employees' performance is influenced by work surroundings and coworkers as much as by employee ability and skill. The Hawthorne studies are credited with focusing managerial strategy on the socio-psychological aspects of human behavior in organizations.



The following video from the AT&T archives contains interviews with individuals who participated in these studies. It provides insight into the way the studies were conducted and how they changed employers' views on worker motivation.



The studies originally looked into the effects of physical conditions on productivity and whether workers were more responsive and worked more efficiently under certain environmental conditions, such as improved lighting. The results were surprising: Mayo

found that workers were more responsive to social factors—such as their manager and coworkers—than the factors (lighting, etc.) the researchers set out to investigate. In fact, worker productivity improved when the lights were dimmed again and when everything had been returned to the way it was before the experiment began, productivity at the factory was at its highest level and absenteeism had plummeted.

What happened was Mayo discovered that workers were highly responsive to additional attention from their managers and the feeling that their managers actually cared about and were interested in their work. The studies also found that although financial incentives are important drivers of worker productivity, social factors are equally important.

There were a number of other experiments conducted in the Hawthorne studies, including one in which two women were chosen as test subjects and were then asked to choose four other workers to join the test group. Together, the women worked assembling telephone relays in a separate room over the course of five years (1927–1932). Their output was measured during this time—at first, in secret. It started two weeks before moving the women to an experiment room and continued throughout the study. In the experiment room, they were assigned to a supervisor who discussed changes with them and, at times, used the women's suggestions. The researchers then spent five years measuring how different variables affected both the group's and the individuals' productivity. Some of the variables included giving two five-minute breaks (after a discussion with the group on the best length of time), and then changing to two ten-minute breaks (not the preference of the group).

Changing a variable usually increased productivity, even if the variable was just a change back to the original condition. Researchers concluded that the employees worked harder because they thought they were being monitored individually. Researchers hypothesized that choosing one's own coworkers, working as a group, being treated as special (as evidenced by working in a separate room), and having a sympathetic supervisor were the real reasons for the productivity increase.

The Hawthorne studies showed that people's work performance is dependent on social issues and job satisfaction. The studies concluded that tangible motivators such as monetary incentives and good working conditions are generally less important in improving employee productivity than intangible motivators such as meeting individuals' desire to belong to a group and be included in decision making and work.

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10.3: 10.3 Need-Based Theories

What you'll learn to do: explain need-based theories of worker motivation

In this section we will look at four main theories about how human needs are satisfied: Maslow's hierarchy of needs, Alderfer's ERG theory, Herzberg's two-factor theory, and McClelland's acquired-needs theory.

Learning Objectives

- Explain the impact that Maslow's levels of needs have on worker motivation
- Explain the difference between intrinsic and extrinsic motivators in Herzberg's two-factor theory
- Describe how employees might be motivated using McClelland's acquired needs theory

Maslow's Hierarchy of Needs

Human motivation can be defined as the fulfillment of various needs. These needs can encompass a range of human desires, from basic, tangible needs of survival to complex, emotional needs surrounding an individual's psychological well-being.

Abraham Maslow was a social psychologist who was interested in a broad spectrum of human psychological needs rather than on individual psychological problems. He is best known for his hierarchy-of-needs theory. Depicted in a pyramid (shown in Figure 1, below), the theory organizes the different levels of human psychological and physical needs in order of importance.

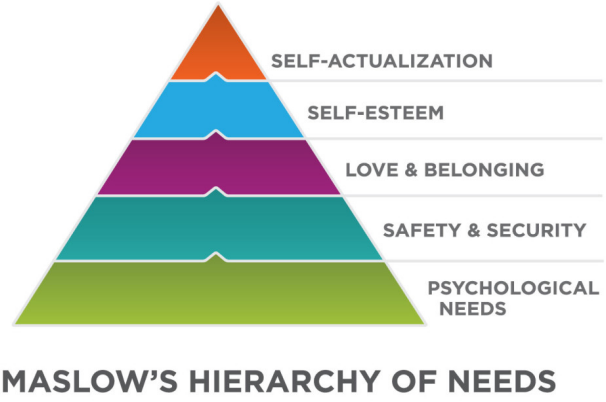


Figure 10.3.1. Maslow's Hierarchy of Needs

The needs in Maslow's hierarchy include physiological needs (food and clothing), safety needs (job security), social needs (friendship), self-esteem, and self-actualization. This hierarchy can be used by managers to better understand employees' needs and motivation and address them in ways that lead to high productivity and job satisfaction.

At the bottom of the pyramid are the physiological (or basic) human needs that are required for survival: food, shelter, water, sleep, etc. If these requirements are not met, the body cannot continue to function. Faced with a lack of food, love, and safety, most people would probably consider food to be their most urgent need.

Once physical needs are satisfied, individual safety takes precedence. Safety and security needs include personal security, financial security, and health and well-being. These first two levels are important to the physical survival of the person. Once individuals have basic nutrition, shelter, and safety, they seek to fulfill higher-level needs.

The third level of need is love and belonging, which are psycho-social needs; when individuals have taken care of themselves physically, they can address their need to share and connect with others. Deficiencies at this level, on account of neglect, shunning, ostracism, etc., can impact an individual's ability to form and maintain emotionally significant relationships. Humans need to feel a sense of belonging and acceptance, whether it comes from a large social group or a small network of family and friends. Other sources of social connection may be professional organizations, clubs, religious groups, social media sites, and so forth. Humans need to love and be loved (sexually and non-sexually) by others. Without these attachments, people can be vulnerable to psychological difficulties such as loneliness, social anxiety, and depression (and these conditions, when severe, can impair a person's ability to address basic physiological needs such as eating and sleeping).

The fourth level is esteem, which represents the normal human desire to be valued and validated by others, through, for example, the recognition of success or status. This level also includes self-esteem, which refers to the regard and acceptance one has for oneself. Imbalances at this level can result in low self-esteem or an inferiority complex. People suffering from low self-esteem may find that external validation by others—through fame, glory, accolades, etc.—only partially or temporarily fulfills their needs at this level.

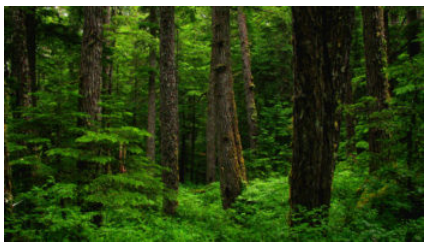
At the top of the pyramid is self-actualization. At this stage, people feel that they have reached their full potential and are doing everything they're capable of. Self-actualization is rarely a permanent feeling or state. Rather, it refers to the ongoing need for personal growth and discovery that people have throughout their lives. Self-actualization may occur after reaching an important goal or overcoming a particular challenge, and it may be marked by a new sense of self-confidence or contentment.

Hierarchy of Needs and Organizational Theory

Maslow's hierarchy of needs is relevant to organizational theory because both are concerned with human motivation. Understanding what people need—and how people's needs differ—is an important part of effective management. For example, some people work primarily for money (and fulfill their other needs elsewhere), but others like to go to work because they enjoy their coworkers or feel respected by others and appreciated for their good work. Maslow's hierarchy of needs suggests that if a lower need is not met, then the higher ones will be ignored. For example, if employees lack job security and are worried that they will be fired, they will be far more concerned about their financial well-being and meeting lower needs (paying rent, bills, etc.) than about friendships and respect at work. However, if employees receive adequate financial compensation (and have job security), meaningful group relationships and praise for good work may be more important motivators.

When needs aren't met, employees can become very frustrated. For example, if someone works hard for a promotion and doesn't get the recognition it represents, she may lose motivation and put in less effort. Also, when a need is met, it will no longer serve a motivating function—the next level up in the needs hierarchy will become more important. From a management point of view, keeping one's employees motivated can seem like something of a moving target. People seldom fit neatly into pyramids or diagrams, and their needs are complicated and often change over time. For example, Maria is a long-time employee who is punctual, does high-quality work, and is well liked by her coworkers. However, her supervisor begins to notice that she is coming in late and seems distracted at work. He concludes that Maria is bored with her job and wants to leave. When he calls her into his office for her semiannual performance appraisal, he brings up these matters. To his surprise and chagrin, the supervisor learns that Maria's husband lost his job six months ago and, unable to keep up with mortgage payments, the two have been living in a local hotel. Maria has moved down the needs pyramid, and, if the supervisor wants to be an effective manager, he must adapt the motivational approaches he uses with her. In short, a manager's best strategy is to recognize this complexity and try to remain attuned to what employees say they need.

Alderfer's ERG Theory



Clayton Paul Alderfer is an American psychologist who developed Maslow's hierarchy of needs into a theory of his own. **Alderfer's ERG theory** suggests that there are three groups of core needs: **existence (E), relatedness (R)**, and **growth (G)**—hence the acronym *ERG*. These groups align with Maslow's levels of physiological needs, social needs, and self-actualization needs, respectively.

"Existence" needs concern our basic material requirements for living. These include what Maslow categorized as physiological needs (such as air, food, water, and shelter) and safety-related needs (such as health, secure employment, and property).

"Relatedness" needs have to do with the importance of maintaining interpersonal relationships. These needs are based in social interactions with others and align with Maslow's levels of love/belonging-related needs (such as friendship, family, and sexual intimacy) and esteem-related needs (gaining the respect of others).

Finally, "growth" needs describe our intrinsic desire for personal development. These needs align with the other portion of Maslow's esteem-related needs (self-esteem, self-confidence, and achievement) and self-actualization needs (such as morality, creativity, problem-solving, and discovery).

Alderfer proposed that when a certain category of needs isn't being met, people will redouble their efforts to fulfill needs in a lower category. For example, if someone's self-esteem is suffering, he or she will invest more effort in the relatedness category of needs.

Intrinsic and Extrinsic Motivators

American psychologist **Frederick Herzberg** is regarded as one of the great original thinkers in management and motivational theory. Herzberg set out to determine the effect of attitude on motivation, by simply asking people to describe the times when they felt really good, and really bad, about their jobs. What he found was that people who felt good about their jobs gave very different responses from the people who felt bad.

The results from this inquiry form the basis of Herzberg's Motivation-Hygiene Theory (sometimes known as Herzberg's "**Two Factor Theory**"). Published in his famous article, "One More Time: How do You Motivate Employees," the conclusions he drew were extraordinarily influential, and still form the bedrock of good motivational practice nearly half a century later. He's especially recognized for his two-factor theory, which hypothesized that are two different sets of factors governing job satisfaction and job dissatisfaction: "hygiene factors," or extrinsic motivators and "motivation factors," or intrinsic motivators.

Hygiene factors, or extrinsic motivators, tend to represent more tangible, basic needs—i.e., the kinds of needs included in the existence category of needs in the ERG theory or in the lower levels of Maslow's hierarchy of needs. Extrinsic motivators include status, job security, salary, and fringe benefits. It's important for managers to realize that not providing the appropriate and expected extrinsic motivators will sow dissatisfaction and decrease motivation among employees.

Motivation factors, or intrinsic motivators, tend to represent less tangible, more emotional needs—i.e., the kinds of needs identified in the "relatedness" and "growth" categories of needs in the ERG theory and in the higher levels of Maslow's hierarchy of needs. Intrinsic motivators include challenging work, recognition, relationships, and growth potential. Managers need to recognize that while these needs may fall outside the more traditional scope of what a workplace ought to provide, they can be critical to strong individual and team performance.

The factor that differentiates two-factor theory from the others we've discussed is the role of employee *expectations*. According to Herzberg, intrinsic motivators and extrinsic motivators have an inverse relationship. That is, intrinsic motivators tend to increase motivation when they are present, while extrinsic motivators tend to reduce motivation when they are absent. This is due to employees' expectations. Extrinsic motivators (e.g., salary, benefits) are expected, so they won't increase motivation when they are in place, but they will cause dissatisfaction when they are missing. Intrinsic motivators (e.g., challenging work, growth potential), on the other hand, can be a source of additional motivation when they are available.

If management wants to increase employees' job satisfaction, they should be concerned with the nature of the work itself—the opportunities it presents employees for gaining status, assuming responsibility, and achieving self-realization. If, on the other hand, management wishes to reduce dissatisfaction, then it must focus on the job environment—policies, procedures, supervision, and working conditions. To ensure a satisfied and productive workforce, managers must pay attention to both sets of job factors.

Watch the following videos to hear these principles explained by Frederick Herzberg himself (in a smoke-filled 1970s lecture theater no less!).

cquired Needs Theory

Psychologist **David McClelland's acquired-needs theory** splits the needs of employees into three categories rather than the two we discussed in Herzberg's theory. These three categories are **achievement**, **affiliation**, and **power**.

Employees who are strongly *achievement-motivated* are driven by the desire for mastery. They prefer working on tasks of moderate difficulty in which outcomes are the result of their effort rather than luck. They value receiving feedback on their work.

Employees who are strongly *affiliation-motivated* are driven by the desire to create and maintain social relationships. They enjoy belonging to a group and want to feel loved and accepted. They may not make effective managers because they may worry too much about how others will feel about them.

Employees who are strongly *power-motivated* are driven by the desire to influence, teach, or encourage others. They enjoy work and place a high value on discipline. However, they may take a zero-sum approach to group work—for one person to win, or succeed, another must lose, or fail. If channeled appropriately, though, this can positively support group goals and help others in the group feel competent.

The acquired-needs theory doesn't claim that people can be neatly categorized into one of three types. Rather, it asserts that all people are motivated by all of these needs in varying degrees and proportions. An individual's balance of these needs forms a kind of profile that can be useful in creating a tailored motivational paradigm for her. It is important to note that needs do not necessarily correlate with competencies; it is possible for an employee to be strongly affiliation-motivated, for example, but still be successful in a situation in which her affiliation needs are not met.

McClelland proposes that those in top management positions generally have a high need for power and a low need for affiliation. He also believes that although individuals with a need for achievement can make good managers, they are not generally suited to being in top management positions.

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10.4: Process-Based Theories

What you'll learn to do: explain process-based theories of motivation

In this section we will discuss three process-based theories of motivation: equity theory, expectancy theory, and reinforcement theory.

Learning Objectives

- Explain the implications of equity theory for business managers
- Explain how reinforcement theory can be used as a management tool

Equity Theory

In contrast to the need-based theories we have covered so far, process-based theories view motivation as a rational process. Individuals analyze their environment, develop reactions and feelings, and respond in certain predictable ways.

Equity theory attempts to explain relational satisfaction in terms of perceived fairness: that is, people evaluate the extent to which there is a fair or unfair distribution of resources within their interpersonal relationships. Regarded as one of many theories of justice, equity theory was first developed in 1963 by **John Stacey Adams.** Adams, a workplace and behavioral psychologist, asserted that employees seek to maintain equity between what they put into a job and what they receive from it against the perceived inputs and outcomes of others.

Equity theory proposes that people value fair treatment, which motivates them to maintain a similar standard of fairness with their coworkers and the organization. Accordingly, equity structure in the workplace is based on the ratio of inputs to outcomes.

Inputs are the employee's contribution to the workplace. Inputs include time spent working and level of effort but can also include less tangible contributions such as loyalty, commitment, and enthusiasm.

Outputs are what the employee receives from the employer and can also be tangible or intangible. Tangible outcomes include salary and job security. Intangible outcomes might be recognition, praise, or a sense of achievement.

For example, let's look at Ross and Monica, two employees who work for a large magazine-publishing company doing very similar jobs. If Ross received a raise in pay but saw that Monica was given a larger raise for the same amount of work, Ross would evaluate this change, perceive an inequality, and be distressed. However, if Ross perceived that Monica were being given more responsibility and therefore relatively more work along with the salary increase, then he would see no loss in equality status and not object to the change.

An employee will feel that he is treated fairly if he perceives the ratio of his inputs to his outcomes to be equivalent to those around him.

Equity theory includes the following primary propositions:

1. Individuals will try to maximize their outcomes.
2. Individuals can maximize collective rewards by evolving accepted systems for equitably apportioning resources among members. As a result, groups will evolve such systems of equity and will attempt to induce members to accept and adhere to these systems. In addition, groups will generally reward members who treat others equitably and punish members who treat others inequitably.
3. When individuals find themselves participating in inequitable relationships, they will become distressed. The more inequitable the relationship, the more distress they will feel. According to equity theory, the person who gets "too much" and the person who gets "too little" both feel distressed. The person who gets too much may feel guilt or shame. The person who gets too little may feel angry or humiliated.
4. Individuals who discover they are in inequitable relationships will attempt to eliminate their distress by restoring equity.

The focus of equity theory is on determining whether the distribution of resources is fair to both relational partners. Partners do not have to receive equal benefits (such as receiving the same amount of love, care, and financial security) or make equal contributions

(such as investing the same amount of effort, time, and financial resources), as long as the ratio between these benefits and contributions is similar.

In other words, Ross perceives equity if Monica makes more money but also has more job responsibilities, because the ratio of inputs (job responsibilities) to outcomes (salary) is about the same. On the other hand, Ross would perceive inequity if the ratio were different—say if Monica made more money for the same job or if Monica made a salary equal to Ross's but had fewer job responsibilities.

When an employee is comparing his input/outcome ratio to his fellow workers', he will look for other employees with similar jobs or skill sets. For example, Ross would not compare his salary and responsibilities to those of the magazine company's CEO. However, he might look outside the organization for comparison—for instance, he might visit glassdoor.com to check salaries for positions like his at other publishing houses.

Much like other prevalent theories of motivation, such as Maslow's hierarchy of needs, equity theory acknowledges that subtle and variable factors affect people's assessment and perception of their standing relative to others. According to Adams, underpayment inequity induces anger, while overpayment induces guilt. Compensation, whether hourly or salaried, is a central concern for employees and is therefore the cause of equity or inequity in most, but not all, cases.

In any position, employees want to feel that their contributions and work performance are being rewarded with fair pay. An employee who feels underpaid may experience feelings of hostility toward the organization and perhaps coworkers. This hostility may cause the employee to underperform and breed job dissatisfaction among others.

Subtle or intangible compensation also plays an important role in feelings about equity. Receiving recognition and being thanked for strong job performance can help employees feel valued and satisfied with their jobs, resulting in better outcomes for both the individual and the organization.

Equity theory has several implications for business managers, as follow:

- Employees measure the totals of their inputs and outcomes. This means a working parent may accept lower monetary compensation in return for more flexible working hours.
- Different employees ascribe different personal values to inputs and outcomes. Thus, two employees of equal experience and qualification performing the same work for the same pay may have quite different perceptions of the fairness of the deal.
- Employees are able to adjust for purchasing power and local market conditions. Thus a teacher from Vancouver, Washington, may accept lower compensation than his colleague in Seattle if his cost of living is different, while a teacher in a remote African village may accept a totally different pay structure.
- Although it may be acceptable for more senior staff to receive higher compensation, there are limits to the balance of the scales of equity, and employees can find excessive executive pay demotivating.
- Staff perceptions of inputs and outcomes of themselves and others may be incorrect, and perceptions need to be managed effectively.

Expectancy Theory

Expectancy theory, initially put forward by **Victor Vroom** at the Yale School of Management, suggests that behavior is motivated by anticipated results or consequences. Vroom proposed that a person decides to behave in a certain way based on the expected result of the chosen behavior. For example, people will be willing to work harder if they think the extra effort will be rewarded.

In essence, individuals make choices based on estimates of how well the expected results of a given behavior are going to match up with or eventually lead to the desired results. This process begins in childhood and continues throughout a person's life. Expectancy theory has three components: expectancy, instrumentality, and valence.

Expectancy is the individual's belief that effort will lead to the intended performance goals. Expectancy describes the person's belief that "I can do this." Usually, this belief is based on an individual's past experience, self-confidence, and the perceived difficulty of the performance standard or goal. Factors associated with the individual's expectancy perception are competence, goal difficulty, and control.

Instrumentality is the belief that a person will receive a desired outcome if the performance expectation is met. Instrumentality reflects the person's belief that, "If I accomplish this, I will get that." The desired outcome may come in the form of a pay increase, promotion, recognition, or sense of accomplishment. Having clear policies in place—preferably spelled out in a contract—

guarantees that the reward will be delivered if the agreed-upon performance is met. Instrumentality is low when the outcome is vague or uncertain, or if the outcome is the same for all possible levels of performance.

Valence is the unique value an individual places on a particular outcome. Valence captures the fact that "I find this particular outcome desirable because I'm me." Factors associated with the individual's valence are needs, goals, preferences, values, sources of motivation, and the strength of an individual's preference for a particular outcome. An outcome that one employee finds motivating and desirable—such as a bonus or pay raise—may not be motivating and desirable to another (who may, for example, prefer greater recognition or more flexible working hours).

Expectancy theory, when properly followed, can help managers understand how individuals are motivated to choose among various behavioral alternatives. To enhance the connection between performance and outcomes, managers should use systems that tie rewards very closely to performance. They can also use training to help employees improve their abilities and believe that added effort will, in fact, lead to better performance.

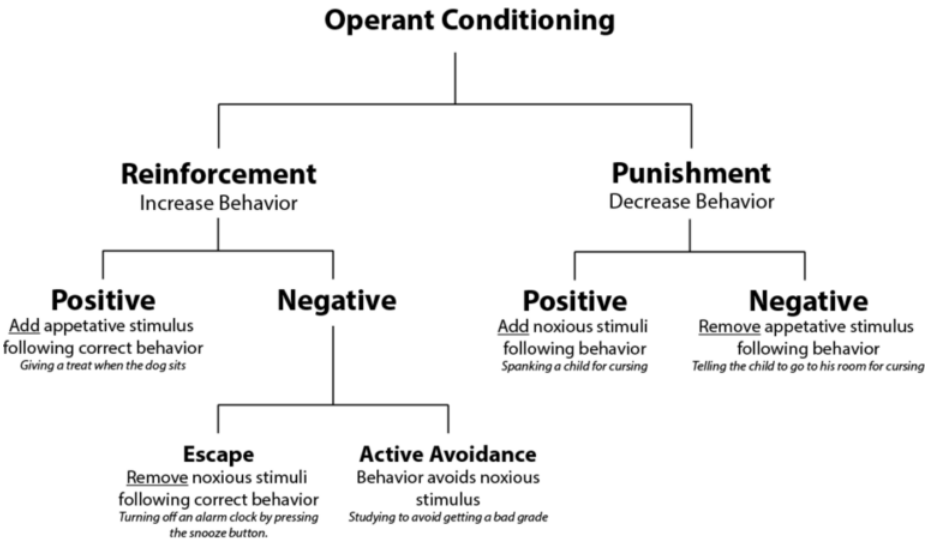
It's important to understand that expectancy theory can run aground if managers interpret it too simplistically. Vroom's theory entails more than just the assumption that people will work harder if they think the effort will be rewarded. The reward needs to be meaningful and take valence into account. Valence has a significant cultural as well as personal dimension, as illustrated by the following case: When Japanese motor company ASMO opened a plant in the U.S., it brought with it a large Japanese workforce but hired American managers to oversee operations. The managers, thinking to motivate their workers with a reward system, initiated a costly employee-of-the-month program that included free parking and other perks. The program was a huge flop, and participation was disappointingly low. Why? The program required employees to nominate their coworkers to be considered for the award. Japanese culture values modesty, teamwork, and conformity, and to be put forward or singled out for being special is considered inappropriate and even shameful. To be named Employee of the Month would be a very great embarrassment indeed—not at all the reward that management assumed. Especially as companies become more culturally diverse, the lesson is that managers need to get to know their employees and their needs—their unique valences—if they want to understand what makes them feel motivated, happy, and valued.

Reinforcement Theory

The basic premise of the theory of reinforcement is both simple and intuitive: An individual's behavior is a function of the consequences of that behavior. You can think of it as simple cause and effect. If I work hard today, I'll make more money. If I make more money, I'm more likely to want to work hard. Such a scenario creates behavioral reinforcement, where the desired behavior is enabled and promoted by the desired outcome of a behavior.

Reinforcement theory is based on work done by **B. F. Skinner** in the field of operant conditioning. The theory relies on four primary inputs, or aspects of operant conditioning, from the external environment. These four inputs are **positive reinforcement, negative reinforcement, positive punishment,** and **negative punishment**.

This following chart shows the various pathways of operant conditioning, which can be established via reinforcement and punishment (both positive and negative for each).



Postive presence of a stimulus

Negative absense of a stimulus

Reinforcement increases behavior

Punishment decreases behavior

Escape removes a stimulus

Avoidance prevents a stimulus

Reinforcement

Positive reinforcement attempts to increase the frequency of a behavior by rewarding that behavior. For example, if an employee identifies a new market opportunity that creates profit, an organization may give her a bonus. This will positively reinforce the desired behavior.

Negative reinforcement, on the other hand, attempts to increase the frequency of a behavior by removing something the individual doesn't like. For example, an employee demonstrates a strong work ethic and wraps up a few projects faster than expected. This employee happens to have a long commute. The manager tells the employee to go ahead and work from home for a few days, considering how much progress she has made. This is an example of removing a negative stimulus as way of reinforcing a behavior.

Reinforcement can be affected by various factors, including the following:

- **Satiation**: the degree of need. If an employee is quite wealthy, for example, it may not be particularly reinforcing (or motivating) to offer a bonus.
- **Immediacy**: the time elapsed between the desired behavior and the reinforcement. The shorter the time between the two, the more likely it is that the employee will correlate the reinforcement with the behavior. If an employee does something great but isn't rewarded until two months after, he or she may not connect the desired behavior with the outcome. The reinforcement loses meaning and power.
- **Size**: the magnitude of a reward or punishment can have a big effect on the degree of response. For example, a bigger bonus often has a bigger impact (to an extent; see the satiation factor, above).

In a management context, reinforcers include salary increases, bonuses, promotions, variable incomes, flexible work hours, and paid sabbaticals.Managers are responsible for identifying the behaviors that should be promoted, the ones that should be discouraged, and carefully consider how those behaviors related to organizational objectives. Implementing rewards and punishments that are aligned with the organization's goals helps to create a more consistent, efficient work culture.

One particularly common positive-reinforcement technique is the incentive program, a formal scheme used to promote or encourage specific actions, behaviors, or results from employees during a defined period of time. Incentive programs can reduce

turnover, boost morale and loyalty, improve wellness, increase retention, and drive daily performance among employees. Motivating staff can, in turn, help businesses increase productivity and meet goals.

Let's look at an IT sales team as an example: The team's overarching goal is to sell their new software to businesses. The manager may want to emphasize sales to partners of a certain size (i.e., big contracts). To this end, the manager may reward team members who gain clients of 5,000 or more employees with a commission of 5 percent of the overall sales volume for each such partner. This reward reinforces the behavior of closing big contracts, strongly motivating team members to work toward that goal, and likely increases the total number of big contracts closed.

To maximize the impact of such a reinforcement, every feature of the incentive program must be tailored to the participants' interests. A successful incentive program contains clearly defined rules, suitable rewards, efficient communication strategies, and measurable success metrics. By adapting each element of the program to fit the target audience, companies are better able to engage participating employees and enhance the overall program efficacy.

Punishment

Positive punishment is conditioning at its most straightforward: identifying a negative behavior and providing an adverse stimulus to discourage future occurrences. A simple example would be suspending an employee for inappropriate behavior.

Negative punishment entails the removal or withholding of something in order to condition a response. For example, an employee in the IT department prefers to work unconventional hours, from 10:30 a.m. to 7 p.m. However, her performance has been suffering lately. A negative punishment would be to revoke her right to keep the preferred schedule until performance improves.

The purpose of punishment is to prevent future occurrences of a particular socially unacceptable or undesirable behavior. According to deterrence theory, the awareness of a punishment can prevent people from engaging in the behavior. This can be accomplished either by punishing someone immediately after the undesirable behavior, so they are reluctant to do it again, or by educating people about the punishment preemptively, so they are inclined not to engage in the behavior at all. In a management context, punishment tools can include demotions, salary cuts, and terminations.

In business organizations, punishment and deterrence theory play a vital role in shaping the work culture to be in line with operational expectations and to avoid conflicts and negative outcomes both internally and externally. If employees know exactly what they are not supposed to do, and they understand the possible repercussions of violating those expectations, they will generally try to avoid crossing the line. Prevention is a much cheaper and easier approach than waiting for something bad to happen, so preemptive education regarding rules—and the penalties for violations—is common practice, especially in the area of business ethics.

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10.5: Theory X, Theory Y, and Theory Z

What you'll learn to do: differentiate between Theory X, Theory Y, and Theory Z managers

In this section you'll learn more about three different managerial styles and their impact on employee motivation. As you read, see if the descriptions fit anyone you have worked for.

Learning Objectives

- Explain the implications of Theory X, Theory Y, and Theory Z for employee management
- Explain the implications of Theory X, Theory Y, and Theory Z for employee management

McGregor's Theory X and Theory Y

The idea that a manager's attitude has an impact on employee motivation was originally proposed by **Douglas McGregor**, a management professor at the Massachusetts Institute of Technology during the 1950s and 1960s. In his 1960 book, *The Human Side of Enterprise*, McGregor proposed two theories by which managers perceive and address employee motivation. He referred to these opposing motivational methods as Theory X and Theory Y management. Each assumes that the manager's role is to organize resources, including people, to best benefit the company. However, beyond this commonality, the attitudes and assumptions they embody are quite different.

Theory X

According to McGregor, Theory X management assumes the following:

- Work is inherently distasteful to most people, and they will attempt to avoid work whenever possible.
- Most people are not ambitious, have little desire for responsibility, and prefer to be directed.
- Most people have little aptitude for creativity in solving organizational problems.
- Motivation occurs only at the physiological and security levels of Maslow's hierarchy of needs.
- Most people are self-centered. As a result, they must be closely controlled and often coerced to achieve organizational objectives.
- Most people resist change.
- Most people are gullible and unintelligent.

Essentially, Theory X assumes that the primary source of employee motivation is monetary, with security as a strong second. Under Theory X, one can take a hard or soft approach to getting results.

The hard approach to motivation relies on coercion, implicit threats, micromanagement, and tight controls— essentially an environment of command and control. The soft approach, however, is to be permissive and seek harmony in the hopes that, in return, employees will cooperate when asked. However, neither of these extremes is optimal. The hard approach results in hostility, purposely low output, and extreme union demands. The soft approach results in a growing desire for greater reward in exchange for diminished work output.

It might seem that the optimal approach to human resource management would lie somewhere between these extremes. However, McGregor asserts that neither approach is appropriate, since the basic assumptions of Theory X are incorrect.

Drawing on Maslow's hierarchy of needs, McGregor argues that a need, once satisfied, no longer motivates. The company uses monetary rewards and benefits to satisfy employees' lower-level needs. Once those needs have been satisfied, the motivation disappears. Theory X management hinders the satisfaction of higher-level needs because it doesn't acknowledge that those needs are relevant in the workplace. As a result, the only way that employees can attempt to meet higher-level needs at work is to seek more compensation, so, predictably, they focus on monetary rewards. While money may not be the most effective way to self-fulfillment, it may be the only way available. People will use work to satisfy their lower needs and seek to satisfy their higher needs during their leisure time. However, employees can be most productive when their work goals align with their higher-level needs.

McGregor makes the point that a command-and-control environment is not effective because it relies on lower needs for motivation, but in modern society those needs are mostly satisfied and thus are no longer motivating. In this situation, one would expect employees to dislike their work, avoid responsibility, have no interest in organizational goals, resist change, etc.—creating,

in effect, a self-fulfilling prophecy. To McGregor, a steady supply of motivation seemed more likely to occur under Theory Y management.

Theory Y

The higher-level needs of esteem and self-actualization are ongoing needs that, for most people, are never completely satisfied. As such, it is these higher-level needs through which employees can best be motivated.

In strong contrast to Theory X, Theory Y management makes the following assumptions:

- Work can be as natural as play if the conditions are favorable.
- People will be self-directed and creative to meet their work and organizational objectives if they are committed to them.
- People will be committed to their quality and productivity objectives if rewards are in place that address higher needs such as self-fulfillment.
- The capacity for creativity spreads throughout organizations.
- Most people can handle responsibility because creativity and ingenuity are common in the population.
- Under these conditions, people will seek responsibility.

Under these assumptions, there is an opportunity to align personal goals with organizational goals by using the employee's own need for fulfillment as the motivator. McGregor stressed that Theory Y management does not imply a soft approach.

McGregor recognized that some people may not have reached the level of maturity assumed by Theory Y and may initially need tighter controls that can be relaxed as the employee develops.

If Theory Y holds true, an organization can apply the following principles of scientific management to improve employee motivation:

- **Decentralization and delegation**: If firms decentralize control and reduce the number of levels of management, managers will have more subordinates and consequently need to delegate some responsibility and decision making to them.
- **Job enlargement**: Broadening the scope of an employee's job adds variety and opportunities to satisfy ego needs.
- **Participative management:** Consulting employees in the decision-making process taps their creative capacity and provides them with some control over their work environment.
- **Performance appraisals:** Having the employee set objectives and participate in the process of self-evaluation increases engagement and dedication.

If properly implemented, such an environment can increase and continually fuel motivation as employees work to satisfy their higher-level personal needs through their jobs.

Ouchi's Theory Z

During the 1980s, American business and industry experienced a tsunami of demand for Japanese products and imports, particularly in the automotive industry. Why were U.S. consumers clambering for cars, televisions, stereos, and electronics from Japan? Two reasons: (1) high-quality products and (2) low prices. The Japanese had discovered something that was giving them the competitive edge. The secret to their success was not what they were producing but how they were managing their people—Japanese employees were engaged, empowered, and highly productive.

Management professor **William Ouchi** argued that Western organizations could learn from their Japanese counterparts. Although born and educated in America, Ouchi was of Japanese descent and spent a lot of time in Japan studying the country's approach to workplace teamwork and participative management. The result was Theory Z—a development beyond Theory X and Theory Y that blended the best of Eastern and Western management practices. Ouchi's theory first appeared in his 1981 book, *Theory Z: How American Management Can Meet the Japanese Challenge.* The benefits of Theory Z, Ouchi claimed, would be reduced employee turnover, increased commitment, improved morale and job satisfaction, and drastic increases in productivity.

Theory Z stresses the need to help workers become generalists, rather than specialists. It views job rotations and continual training as a means of increasing employees' knowledge of the company and its processes while building a variety of skills and abilities. Since workers are given much more time to receive training, rotate through jobs, and master the intricacies of the company's operations, promotions tend to be slower. The rationale for the drawn-out time frame is that it helps develop a more dedicated,

loyal, and permanent workforce, which benefits the company; the employees, meanwhile, have the opportunity to fully develop their careers at one company. When employees rise to a higher level of management, it is expected that they will use Theory Z to "bring up," train, and develop other employees in a similar fashion.

Ouchi's Theory Z makes certain assumptions about workers. One assumption is that they seek to build cooperative and intimate working relationships with their coworkers. In other words, employees have a strong desire for affiliation. Another assumption is that workers expect reciprocity and support from the company. According to Theory Z, people want to maintain a work-life balance, and they value a working environment in which things like family, culture, and traditions are considered to be just as important as the work itself. Under Theory Z management, not only do workers have a sense of cohesion with their fellow workers, they also develop a sense of order, discipline, and a moral obligation to work hard. Finally, Theory Z assumes that given the right management support, workers can be trusted to do their jobs to their utmost ability and look after for their own and others' well-being.

Theory Z also makes assumptions about company culture. If a company wants to realize the benefits described above, it need to have the following:

- **A strong company philosophy and culture**: The company philosophy and culture need to be understood and embodied by all employees, and employees need to believe in the work they're doing.
- **Long-term staff development and employment:** The organization and management team need to have measures and programs in place to develop employees. Employment is usually long-term, and promotion is steady and measured. This leads to loyalty from team members.
- **Consensus in decisions:** Employees are encouraged and expected to take part in organizational decisions.
- **Generalist employees:** Because employees have a greater responsibility in making decisions and understand all aspects of the organization, they ought to be generalists. However, employees are still expected to have specialized career responsibilities.
- **Concern for the happiness and well-being of workers:** The organization shows sincere concern for the health and happiness of its employees and their families. It takes measures and creates programs to help foster this happiness and well-being.
- **Informal control with formalized measures:** Employees are empowered to perform tasks the way they see fit, and management is quite hands-off. However, there should be formalized measures in place to assess work quality and performance.
- **Individual responsibility**: The organization recognizes the individual contributions but always within the context of the team as a whole.

Theory Z is not the last word on management, however, as it does have its limitations. It can be difficult for organizations and employees to make life-time employment commitments. Also, participative decision-making may not always be feasible or successful due to the nature of the work or the willingness of the workers. Slow promotions, group decision-making, and life-time employment may not be a good fit with companies operating in cultural, social, and economic environments where those work practices are not the norm.

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10.6: Strategies for Motivating Employees

What you'll learn to do: explain how managers can use job characteristics and goal-setting theory to motivate employees

In this section you'll study two methods used by managers to put motivational theory into practice: job models and goals. These two practices can be observed in almost every organization, profit and nonprofit alike. You'll also see some examples of the way companies are actually implementing those practices today.

learning Objectives

- Describe ways in which goal setting can improve employee performance
- Describe ways in which goal setting can improve employee performance

Job Design and Job Characteristics Theory

Job design is an important prerequisite to workplace motivation, as a well-designed job can encourage positive behaviors and create a strong infrastructure for employee success. Job design involves specifying the contents, responsibilities, objectives, and relationships required to satisfy the expectations of the role. Below are some established approaches managers can take to doing it thoughtfully and well.

Job Characteristics Theory

Proposed by Greg R. Oldham and J. Richard Hackman in 1976, job characteristics theory identifies five core characteristics that managers should keep in mind when they are designing jobs. The theory is that these dimensions relate to, and help satisfy, important psychological states of the employee filling the role, with the results of greater job satisfaction and motivation and less absenteeism and turnover.

Core Job Characteristics

Below are the core job characteristics:

- **Skill variety:** Doing the same thing day in, day out gets tedious. The solution to design jobs with enough variety to stimulate ongoing interest, growth, and satisfaction.
- **Task identity:** Being part of a team is motivating, but so, too, is having some ownership of a set of tasks or part of the process. Having a clear understanding of what one is responsible for, with some degree of control over it, is an important motivator.
- **Task significance:** Feeling relevant to organizational success provides important motivation for getting a task or job done. Knowing that one's contributions are important contribute's to sense of satisfaction and accomplishment.
- **Autonomy**: No one likes to be micromanaged, and having some freedom to be the expert is critical to job satisfaction. Companies usually hire people for their specialized knowledge. Giving specialists autonomy to make the right decisions is a win-win.
- **Feedback**: Finally, everyone needs objective feedback on how they are doing and how they can do better. Providing well-constructed feedback with tangible outcomes is a key component of job design.

In the following Ted Talk, career analyst Dan Pink examines the puzzle of motivation, starting with a fact that social scientists know but most managers don't: Traditional external rewards aren't always as effective as we think, and those that speak to a person's internal motivation are often more potent and lasting:

Psychological States

Below are the psychological states that help employees feel motivated and satisfied with their work:

- **Experienced meaningfulness:** This is a positive psychological state that will be achieved if the first three job dimensions—skill variety, task identity, and task significance—are in place. All three dimensions help employees feel that what they do is meaningful.
- **Experienced responsibility:** Dimension four, autonomy, contributes to a sense of accountability, which, for most, people is intrinsically motivating.
- **Knowledge of results:** Dimension five, feedback, provides a sense of progress, growth, and personal assessment. Understanding one's accomplishments is a healthy state of mind for motivation and satisfaction.

Work Outcomes

The combination of core job characteristics with psychological states influences work outcomes such as the following:

- **Job satisfaction**: When employees feel that their jobs are meaningful, that positive psychological state contributes to a sense of satisfaction.
- **Motivation**: Employees who experience responsibility in their job, a sense of ownership over their work, and knowledge of the results tend to be more highly motivated.
- **Absenteeism**: When employees are motivated and satisfied, absenteeism and job turnover decrease.

Overall, the manager's goal is to design the job in such a way that the core characteristics complement the psychological states of the worker and lead to positive outcomes.

Job Design Techniques

As a motivational force in the organization, managers must consider how they can design jobs that lead to empowered, motivated, and satisfied employees. Below are a few established methods to accomplish this objective:

- **Job rotation**: As noted in the above model, it's not particularly motivating to do the exact same thing every day. As a result, rotating jobs and expanding employees' skill sets accomplish two objectives: increased employee satisfaction and broader employee skills.
- **Job enlargement (horizontal):** Giving employees the autonomy to step back and assess the quality of their work, improve the efficiency of their processes, and address mistakes contributes to satisfaction in the workplace.
- **Intrinsic and extrinsic rewards**: Giving employees autonomy helps generate intrinsic rewards (self-satisfaction) and motivation. Extrinsic rewards (such as time off, a bonus, or commission) are also motivating.
- **Job enrichment (vertical)**: It's important for managers to delegate some of their planning to seasoned employees as they grow into their roles. By turning over control of work-task planning to employees themselves, they feel a strong sense of engagement, progress in their career, and ownership of their work outcomes.

Goal-Setting Theory

Goal Setting

Athletes set goals during the training process. Through choice, effort, persistence, and cognition, they can prepare to compete.

Research shows that people perform better when they are committed to achieving particular goals. Factors that help ensure commitment to goals include the following:

- The importance of the expected outcomes
- Self-efficacy, or belief that the goal can be achieved
- Promises or engagements to others, which can strengthen commitment level

In a business setting, managers cannot constantly drive employees' motivation or monitor their work from moment to moment. Instead, they rely on goal setting as an effective means of helping employees regulate their own performance and stay on track. Goal setting affects outcomes in the following important ways:

- **Choice**: Goals narrow attention and direct efforts to goal-relevant activities, and away from goal-irrelevant actions.
- **Effort**: Goals can lead to more effort; for example, if one typically produces four widgets per hour and has the goal of producing six, one may work more intensely to reach the goal than one would otherwise.
- **Persistence:** People are more likely to work through setbacks if they are pursuing a goal.
- **Cognition**: Goals can lead individuals to develop and change their behavior.

Edwin Locke and his colleagues examined the behavioral effects of goal setting, and they found that 90 percent of laboratory and field studies involving specific and challenging goals led to higher performance, whereas those with easy or no goals showed minimal improvement. While some managers believe it is sufficient to urge employees to "do their best," these researchers learned that people who are instructed to do their best generally do not. The reason is that if you want to elicit a specific behavior, you need to give a clear picture of what is expected. "Do your best" is too vague. A goal is important because it establishes a specified direction and measure of performance.

You'll recall from the discussion of SMART objectives in the Management module that setting effective goals and identifying the best means of meeting them are important aspects of the controlling function of managers. It turns out that setting SMART goals is also a powerful way to motivate employees, especially when employees are able to participate in the goal-setting process. **S**pecific, **M**easurable, **A**chievable, **R**ealistic, and **T**ime-constrained goals give both managers and employees clear direction and a way to measure performance.

Goals and Feedback

Aim for the goal: goal-setting is closely tied to performance. Those who set realistic but challenging goals are likely to perform better than those who do not.

Managers need to track performance so employees can see how effective they have been in attaining their goals. Without proper feedback channels, employees find it impossible to adapt or adjust their behavior. Goal setting and feedback go hand-in-hand. Without feedback, goal setting is unlikely to work.

Providing feedback on short-term objectives helps to sustain an employee's motivation and commitment. When giving feedback, managers should do the following:

- Create a positive context
- Use constructive and positive language
- Focus on behaviors and strategies
- Tailor feedback to the needs of the individual worker
- Make feedback a two-way communication process

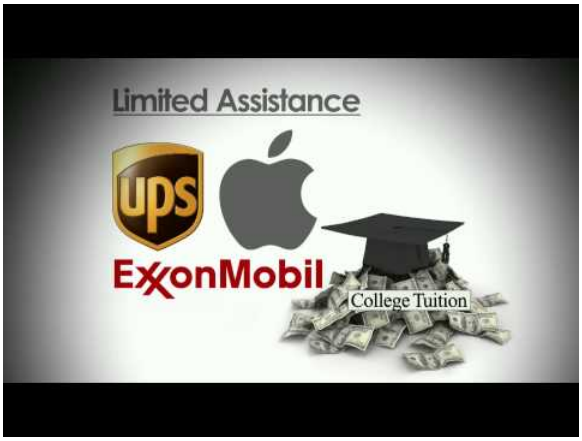
Goal setting may have little effect if the employee can't evaluate his own performance in relation to the goal. By giving accurate, constructive feedback, managers can help employees evaluate whether they need to work harder or change their approach.

Goal-setting theory is very useful in business, but it does have limitations. Using production targets to drive motivation may encourage workers to meet those targets by any means necessary—resulting in poor quality or, worse, unethical behavior. You'll recall that this was the case in the recent Wells Fargo scandal, where employees created millions of fake bank accounts in order to hit sales targets. Another problem with goal setting is that a manager's goals may not be aligned with the goals of the organization as whole, and conflict may ensue, or the employees may feel uncertain about which goals ought to be prioritized (first the manager's, then the organization's? Or vice versa?). Either way, performance can suffer. In addition, for complex or creative tasks, it is possible for goal setting to actually hamper achievement, because the individual can become too preoccupied with meeting

goals and distracted from completing tasks. This is especially true is if reviews and pay increases are strongly tied to goal achievement.

Motivation in Today's Workplace

The following videos contain examples of motivational theory being used in today's companies. As you watch, see if you can recognize any of the theories you've studied. Are they need based or process based? What are the results of the different motivational strategies these companies use?



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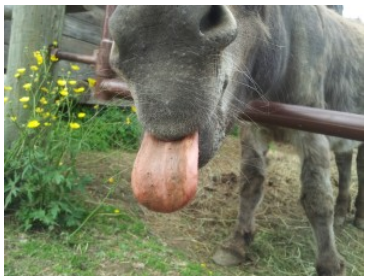
10.7: Putting It Together- Motivating Employees

Synthesis

"You can't make me."



Have you ever heard the expression "stubborn as a mule" and heard it used to describe someone who won't change their mind or way of doing things? What would it take to get such a mulish person to change, to work in a different way—say, more efficiently or effectively? Well, now that you have some motivational theories under your belt, you probably have some ideas. Being able to motivate people is obviously an invaluable skill—in business and in life—and it's not surprising that the most effective leaders and managers are those who can inspire others to work hard and get things done.

At the beginning of this module you were asked what motivates you, how you motivate others, and which strategies have worked (or not worked) for you. Now that you have completed the module, reflect on your answers to those questions. Can you identify some of these motivational theories at work in your own motivations? Do you have a better understanding of where your own motivation comes from?

One last thought as we conclude the module. When you came up with your list of motivating factors, it was your list. What motivates you might not motivate the person working beside you. So, as you interact with people throughout your personal and professional life, keep in mind that motivation is highly variable. It doesn't mean that the theories are wrong or completely irrelevant—it's just that everyone, like you, is motivated by a different set of needs, wants, and aspirations, and you'll need to understand those differences before creatively engaging with them. If you can, you'll be well on your way to being an effective leader and achieving great things.

Summary

In this module you learned about motivation and how organizations can use motivation theory to achieve organizational goals and objectives. The following is a summary of the key points.

The Hawthorne Effect

Conducted at the Western Electric Hawthorne Works plant in Cicero, Illinois, Elton Mayo and his colleagues attempted to apply Taylor's process of scientific management by conducting experiments in the workplace. What resulted is a phenomenon known as the "Hawthorne effect," which occurs when subjects being studied change their behavior simply because they are being observed and treated differently.

Need-Based Theories

The first theories used to explain human motivation were need based. These theories proposed that people are mainly motivated by trying to meet certain needs and that if you can understand their needs, you can better motivate them. Among the need-based theories are Maslow's hierarchy of needs, ERG theory, Herzberg's two-factor theory, and McClelland's acquired-needs theory.

Process-Based Theories

Process-based theories of motivation view motivation as a more rational, deliberate process. The three best-known process-based theories are equity, expectancy, and reinforcement theories.

Theory X, Theory Y, and Theory Z

Douglas McGregor theorized that worker motivation is closely linked to the way managers view and treat their workers and that all managers fall into one of two types—Theory X and Theory Y. Later, William Ouchi combined Eastern and Western management practices to develop Theory Z

Strategies for Motivating Employees

Two methods of applying motivation theory in the workplace are job models and goal setting. Beyond these two applications, companies have become very aware of the way motivated employees impact organizational effectiveness and efficiency.

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CHAPTER OVERVIEW

11: Teamwork and Communication

11.1: Why It Matters- Teamwork and Communication
11.2: Teams
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11.4: Effective Communication and Barriers
11.5: Communication Channels, Flows, and Networks
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11.1: Why It Matters- Teamwork and Communication

Why explain the importance of teamwork and effective communication in a business environment?

Why do businesses stress teamwork and communication? Why have you been subjected to the dreaded “group project” in some of your classes? We think of ourselves as individuals, each hired or chosen for our individual expertise, talents, and experience, and yet we are often asked to work with others on assignments and projects. Why? Because we are capable of so much more when we work together. In this module you will learn about teams, why businesses use them, why they succeed, and why they fail. As part of our examination of teamwork, we’ll also look at the critical role communication plays in helping businesses achieve their goals and objectives, and also some of the challenges they face in using electronic communication.

In the following video, Steve Jobs explains the value of collaboration at Apple—a company that, he says, is great at teamwork and relies on trust, not hierarchy.

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11.2: Teams

What you'll learn to do: differentiate between groups and teams, and describe the characteristics of different types of teams

Not every group of people is a team! Teams within organizations have unique characteristics and are often created for specific purposes. In this section you'll learn about the difference between groups and teams and some types of teams that companies commonly use.

Learning Objectives

- Differentiate between manager-led teams, self-managed teams, functional teams, cross-functional, virtual teams, and project teams

Differences Between Groups and Teams

Difference between Group and Team

Is there a difference between a group and a team? Isn't a collection of people just a collection of people regardless of what we call them? A **group** is comprised of two or more individuals who share common interests or characteristics, and its members identify with one another due to similar traits. A **team**, on the other hand, is a group of people with different skills and different tasks, who work together on a common project, service, or goal, combining their functions and providing mutual support along the way. Watch the following video, keeping those two definitions in mind.

How many groups could you identify in the video? The bees were a group, the butterflies were a group, and the dung beetle who got the cap off the bottle was, well, sort of a group of one. What you saw in this commercial was the transformation of individuals, small groups, and even some larger groups into a *team*. In a team, the members work together toward a common goal and share responsibility for the team's success. In our video example, no group *alone* could have achieved the desired outcome of getting that bottle of Coca Cola open. Instead of focusing on enterprising insects, our discussion will focus on a specific kind of team: the work team.

Why Organizations Build Teams

In the last twenty years or so, teams have become a ubiquitous feature of corporate America. The primary benefit of teams and teamwork is that they allow an organization to achieve goals that individuals working alone may not. This advantage arises from

several factors, each of which contributes to the overall benefit of teams. Two of these —higher-quality outcomes and individual context—are described below:

Higher-Quality Outcomes

Teamwork produces outcomes that make better use of resources and yield richer ideas.

- Higher efficiency: Since teams combine the efforts of individuals, they can accomplish more than an individual working alone.
- Faster speed: Because teams draw on the efforts of many contributors, they can often complete tasks and activities in less time.
- More thoughtful ideas: Each person who works on a problem or set of tasks may bring different information and knowledge to bear, which can result in solutions and approaches an individual may not have identified.
- Greater effectiveness: When people coordinate their efforts, they can divide up roles and tasks to more thoroughly address an issue. For example, in hospital settings teamwork has been found to increase patient safety more than when only individual efforts are made to avoid mishaps.

Better Context for Individuals

The social aspect of teamwork provides a superior work experience for team members, which can motivate higher performance.

- Mutual support: Because team members can rely on other people with shared goals, they can receive assistance and encouragement as they work on tasks. Such support can encourage people to achieve goals they may not have had the confidence to have reached on their own.
- Greater sense of accomplishment: When members of a team collaborate and take collective responsibility for outcomes, they can feel a greater sense of accomplishment when they achieve a goal they could not have achieved if they had worked by themselves.

The total value created by teamwork depends on the overall effectiveness of the team effort.

Types of Teams

There are many types of work teams, and they range in the degree of autonomy afforded to team members. As with the different styles of management (e.g., autocratic, democratic), there are trade-offs with each kind of team structure, so it's important to understand when each type of team should be used.

Self-Managed Teams

A **self-managed team** is a group of employees working together who are accountable for most or all aspects of their task. These work teams determine how they will accomplish assigned objectives and decide what route they will take to meet them. They are granted the responsibility of planning, scheduling, organizing, directing, controlling and evaluating their own work process. They also select their own members and evaluate the members' performance. In this way they share both the managerial and technical tasks. As a result, supervisory positions take on decreased importance and may even be eliminated.

Electronic Arts Inc. is a leading global interactive entertainment software company. EA develops, publishes, and distributes interactive software worldwide for video game systems, personal computers, wireless devices, and the Internet. The company's 2016 revenues were more than $3.5 billion, and it has 8,000 employees in more than 23 countries. Electronic Arts launched internal collaborative communities (i.e., self-managed teams) in 2009 across its globally distributed workforce. Its goal was to gain the efficiencies of a large enterprise without compromising local teams' autonomy or creativity. The communities formed at EA were empowered to make decisions and to deliver. EA's communities could recommend the next technology road map or they could change a business process to become more effective or efficient. There were no limits placed on the types of communities within EA.

Within the company, the real power of these self-managed teams or communities is to work collaboratively to achieve a common goal – to create a new product or service, improve the effectiveness of a business process, or even to eliminate operational inefficiencies. To achieve its goals and to empower its

communities to make decisions, EA explicitly focused on a “light” governance structure that promotes the organic interaction of teams and empowers them to produce a desired business outcome.

Project Teams

A **project team** is a team whose members usually belong to different groups but are assigned activities for the same project. Usually project teams are only used for a defined period of time and are disbanded after the project is deemed complete. The central characteristic of project teams in modern organizations is the autonomy and flexibility given to them in the process of meeting their goals. The project team usually consists of a variety of members working under the direction of a project manager or a senior member of the organization. Project teams need to have the right combination of skills, abilities, and personality types to achieve collaborative tension.

When companies develop new products, they frequently take a project-team approach. A new product requires expertise from around the company—from marketing, operations, legal, accounting/analysis, sales, engineering/operations, and strategy. Omitting any of these vital perspectives or getting a factor wrong can cause the new product to fail.

Proctor and Gamble has become a new-product-development giant by studying this work process. The company choose small teams comprised of dedicated employees, since part-timers are often too distracted by other assignments. P&G sets the team goal as “winning in the marketplace,” not just getting a product out the door.[1]

Cross-Functional Teams

A **cross-functional team** is just what it sounds like—a team that pulls its members from across the different functional areas of an organization. For example, cross-functional teams may be composed of representatives from production, sales, marketing, finance, and legal. The strength of this type of team lies in its members having different functional backgrounds, education, and experience. The diversity of experience aids innovative problem solving and decision making.

Unfortunately, the very factors that give cross-functional teams strength can also lead to weaknesses. Without a strong leader and very specific goals, it may be hard to foster social cohesion in cross-functional teams and to create a system of accountability. A cross-functional team might be brought together to review and make recommendations on potential acquisitions or mergers.

Manager-Led Teams

In a **manager-led team**, the team members complete the required tasks, but someone outside the team (i.e., a manager) performs the executive functions. There is an inevitable tension between the degree of manager control in a team and the ability of team members to guide and manage their own actions. Manager-led teams provide more control, but they can also hamper creativity and individual expression.

The Arts Council of the Albemarle has received a significant gift from a community donor to create a drama workshop for neighborhood youth. As the director of community outreach, Margaret has put together a team to develop the workshop. Among those selected are a program director, a senior program lead, and a program staff member who is studying performing arts at the local university. Margaret assigns each of them specific tasks and responsibilities and creates a schedule for team meetings to discuss progress on the development of the program. She is interested in cultivating a strong relationship with the community donor, and therefore she is very involved in the team’s progress. She meets with the members on a regular basis to ensure that all efforts are on target along the way. While Margaret is, in effect, the team’s manager, the team members must work closely with one another to integrate the elements of the workshop. For example, the play must appeal to the donors, students, parents, and audiences while also being within reach of the instructors’ and students’ abilities.

Virtual Teams

A **virtual team** is a group of individuals in different geographic locations who use technology to collaborate on work tasks and activities. The use of this kind of work team has become prevalent in organizations due to the reduced costs of technology, the increased availability of collaborative technologies (videoconferencing software, etc.), the shift toward globalization in business, and greater use of outsourcing and temporary workers. They offer flexibility around the logistics of doing business since team members can “meet” from any location—wherever they happen to be, such as a home office, coffee shop, etc.—at any time of the day or week. Many of the other types of work teams can also be virtual teams, depending on the organization’s needs and resources.

1. Cooper, R. G., & Mills, M. S. (2005, October). Succeeding at Product Development the P&G Way. Retrieved March 14, 2017, from http://www.stage-gate.net/downloads/wp/wp_21.pdf ↵

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11.3: Team Development and Success

What you'll learn to do: explain the stages of team development and the factors that contribute to team success

Building a well-functioning, cohesive team of people doesn't happen overnight—it's a process. In this section you will learn about the stages of team development and the factors that contribute to team success.

Learning Objectives

- Explain the factors that contribute to team success

Stages of Team Development

When teams develop, they move through a series of stages, beginning when they are formed and ending when they are disbanded. Bruce Tuckman identified four distinct stages of team development: *forming*, *storming*, *norming*, and *performing*. He later added a fifth stage, *adjourning*, which is especially important for self-directed teams and project-based teams that form to reach a specific goal. Each stage has a primary purpose and a common set of interpersonal dynamics among team members. Tuckman proposed that all of these stages are inevitable and even necessary parts of a successful team's evolution.

The Forming Stage

The first step in a team's life is bringing together a group of individuals. Individuals focus on defining and assigning tasks, establishing a schedule, organizing the team's work, and other start-up matters. In addition to focusing on the scope of the team's purpose and means of approaching it, individuals in the formation stage are also gathering impressions and information about one another. Since people generally want to be accepted by others, during this period they usually avoid conflict and disagreement. Team members may begin to work on their tasks independently, not yet focused on their relationships with fellow team members.

Marcus Enterprises has a new product—the Mouse Zapper 2000—that it believes could revolutionize home pest control. Mr. Marcus, the founder of the company has decided that putting together a product launch team is the way to proceed. He selects a group of five employees from across the company and creates the Mouse Zapper Team. He holds a kickoff meeting and shares with them his vision for the product and what he wants them to accomplish as a team: successfully introduce the product to the market within six months, maintain the company's target profit margin of 25 percent, and ship at least ten thousand units from the warehouse in Poughkeepsie, New York. The team is formed at this initial meeting, and when Mr. Marcus leaves the meeting his confidence in the project is high.

The Storming Stage

Once their efforts are under way, team members need clarity about their activities and goals, as well as explicit guidance about how they will work independently and collectively. This leads to a period known as storming—because it can involve brainstorming ideas and also because it usually causes disruption. During the storming stage members begin to share ideas about what to do and how to do it that compete for consideration. Team members start to open up and confront one another's ideas and perspectives.

Because storming can be contentious, members who are averse to conflict may find it unpleasant or even painful. This can decrease motivation and effort by drawing attention away from tasks. In some cases storming (i.e., disagreements) can be resolved quickly. Other times a team never leaves this stage and becomes stuck and unable to do its work. Patience and consideration toward team members and their views go a long way toward avoiding this problem.

Julia, the leader of the Mouse Zapper Team, comes to Mr. Marcus thirty days after the initial meeting. She has a laundry list of issues to discuss, and none of them is pleasant. Marcie from marketing has scheduled focus group sessions, but the final prototype of the Zapper will not be completed in time for the first session. John from production is having to pay overtime to get the prototype finished, which has angered Jim from finance because now he has to account for higher front-end costs that will eat into the targeted 25 percent profit margin. Jill from sales has missed the last two team meetings, and Julia thinks it's because Marcie and Jim got into a heated discussion at an earlier team meeting, which led to Jim slamming his fist on the table and storming out of the room. At this point Julia just wants to get the project moving again.

The Norming Stage

Successfully moving through the storming stage means that a team has clarified its purpose and its strategy for achieving its goals. It now transitions to a period focused on developing shared values about how team members will work together. These norms of collaboration can address issues ranging from when to use certain modes of communication, such as e-mail versus telephone, to how team meetings will be run and what to do when conflicts arise. Norms become a way of simplifying choices and facilitating collaboration, since members have shared expectations about how work will get done.

Mr. Marcus sees Julia in the break room sixty days into the project and casually asks how things are going with the team and the Zapper. Julia reports that things have settled down and she feels like the team is working well together. She says that she met with each team member individually and explained their role in the project and gave them a chance to share any concerns they had. She spent a lot of time listening and taking notes. After the individual meetings, she had Joan from human resources come to a team meeting and conduct some team-building exercises and engaging teamwork activities. The result of the session with Joan was a Mouse Zapper Team vision statement that everyone agreed upon.

The Performing Stage

Once norms are established and the team is functioning as a unit, it enters the performing stage. By now team members work together easily on interdependent tasks and are able to communicate and coordinate effectively. There are fewer time-consuming distractions based on interpersonal and group dynamics. For this reason, motivation is usually high and team members have confidence in their ability to attain goals.

The Mouse Zapper Team begins to hold weekly meetings to share and track progress with all of the members. They have created a channel on the mobile app Slack so the team can instant-message all or some of the members. Communication is flowing in all directions, everyone is engaged, and it looks like they will meet the launch date originally set by Mr. Marcus at the first meeting. The cost of the Zapper is within the profit target, and production has assured everyone that they can produce the required number of Zappers. There are still times when members disagree and team leader Julia has to step in to referee, but the disagreements are quickly resolved and everyone is able to get back to the task at hand—getting the Mouse Zapper 2000 to market.

While these four stages—forming, storming, norming, and performing—are distinct and generally sequential, they often blend into one another and even overlap. A team may pass through one phase only to return to it. For example, if a new member joins the team, there may be a second brief period of formation while that person is integrated. A team may also need to return to an earlier stage if its performance declines. Team-building exercises are often done to help a team through its development process.

The Adjourning Stage

Bruce Tuckman, jointly with Mary Ann Jensen, added the adjourning stage to describe the final stretch of a team's work together. It includes both the last steps of completing the task and breaking up the team. Some work teams are ongoing, like a development team in a software company, for example, so they may not actually "adjourn," but they may still participate in aspects of this stage—by winding up a particularly intense period of collaboration, for example. For project-based teams that have been formed for a limited time period, this stage provides an opportunity to formally mark the end of the project. The team may decide to organize some sort of celebration or ceremony to acknowledge contributions and achievements before it disbands. The adjourning stage is an important way of providing closure, and it can help team members successfully move on to the next work project or team with the sense of a job well done.

Six months and three days after the initial formation of the Mouse Zapper Team, the loading dock of the Poughkeepsie, New York, warehouse is buzzing with excitement. There are balloons, music, cake, and streamers everywhere. The entire Mouse Zapper Team and Mr. Marcus are surrounded by employees and managers from every level within Marcus Enterprises. The celebration? A case of the Mouse Zapper 2000 has been loaded onto a UPS truck, and in that case is Mouse Zapper 2000 number 10,000—headed to a local hardware store in Cleveland, Ohio. The Mouse Zapper is a tremendous success, and the team has met its goals. After the truck pulls away from the loading dock, Mr. Marcus presents each team member with a company-logo lapel pin and a heartfelt thanks for doing such a good job. Now that the Mouse Zapper 2000 has launched, the individual team members will go back to their regular duties, but as Julia walks past Jim and Marcie, she hears Jim say, "I wonder what the next project will be?"

Team Mouse Zapper has formed, stormed, normed, performed, and adjourned—successfully.

Team Success

The way team members function as a group is as important to the team's success as the quality of what it produces. There are many factors that play a role in team success, and the following is by no means an exhaustive list. However, teams that lack the factors below will likely struggle to function well.

Trust

Teams work better when members trust one another. Trust helps people be more willing to share ideas, ask questions, seek guidance, and admit mistakes. Lack of trust can hinder effective communication and efficient work processes.

Effective Communication

Effective communication is vital to team success; it's important for the team to communicate well among its own members, as well as outside the team with relevant parts of the organization. Communication affects nearly every aspect of teamwork—from interpersonal discussions and the exchange of ideas to communication about progress and results.

Common Goal

Having a common goal helps team members build group cohesion and understand that they are working together with a common purpose. If the goal is vague or isn't shared by all, team members may be confused about where their efforts should be directed or reluctant to contribute at all.

Defined Team Roles and Responsibilities

When team members have well-defined roles and responsibilities, they are better able to understand what is expected, stay on track, make appropriate contributions, and avoid duplicating other team members' efforts.

Group Cohesion

Group cohesion arises when bonds link members of a team to one another and to the team as a whole. Members of strongly cohesive teams are more inclined to participate readily and to stay with the team. Cohesion is thought to develop from a heightened sense of belonging, task commitment, interpersonal and group-level attraction, and group pride. In a highly cohesive team, the members like being in the group and find it satisfying.

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11.4: Effective Communication and Barriers

What you'll learn to do: explain the importance of effective communication within an organization, and describe common barriers to effective communication

In this section you'll learn why effective communication is so important in business and what can get in the way of it.

Learning Objectives

- Describe common barriers to effective communication

Effective Communication and Barriers

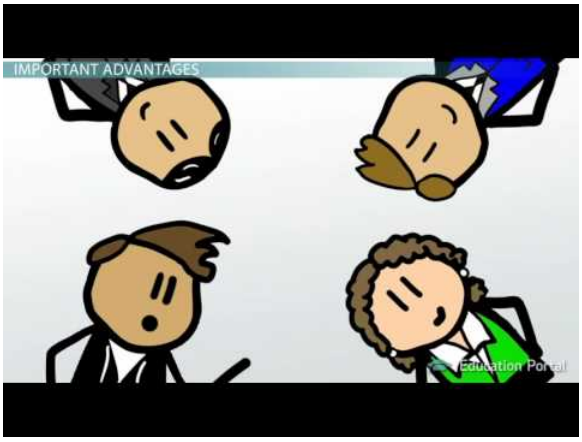
Importance of Effective Communication

The simplest model of communication relies on three distinct parts: sender, message, and receiver. More complex models add a fourth element: the channel used to send the message. We'll talk more about channels later in this module, but for now, you can think of the channel as the medium, or form, of the message. Channels can take verbal, nonverbal, and written forms. Emails, conversations, video conferences, television ads, and Web site publications are all examples of specific communication channels.

In business, the sender and receiver roles can be filled by many people within and outside of the organization: For example, a manager (sender) holds a meeting with an employee (receiver) to discuss the employee's performance. The marketing department (sender) publishes a product launch announcement to reach potential customers (receivers).

There is also an enormous range in the kinds of communication that take place within and to and from an organization. For example, business communication is used to promote products, services, or an organization; relay information within a business; or deal with legal and similar issues. It encompasses a variety of topics including consumer behavior, advertising, public relations, event management, corporate communication, research and measurement, and reputation management. Business communication may also refer to internal communication: In a large company, a communications director may be in charge of managing internal communication and crafting the messages sent to employees. From an HR point of view, effective communication within an organization is vital to building trust and job satisfaction among employees.

The following short video touches on some additional benefits of good communication in the workplace:



Barriers to Effective Communication

Failures of human communication can become amplified in professional settings. In business transactions, especially those involving large amounts of money, a small miscommunication can have devastating effects. Or, if a company fails to lay out a clear, comprehensible set of objectives, the employees tasked with meeting them will probably also fail. If a business makes inaccurate or misleading claims about its products, that can have damaging consequences, as well—possibly causing it to lose customers or, worse, find itself in a lawsuit. For these reasons and many more, it's important for businesses to communicate clearly, consistently, and honestly. It's also important to be informed about the things that get in the way of communication and seek to overcome them. The following is a list of common barriers to communication:

- **The use of jargon**: The use of unfamiliar, overcomplicated, or technical terms can generate confusion and obscure meaning of the sender's message. The solution is to use clear and concise messages that are easy to understand.
- Withholding information: Within an organization, some information is kept confidential due to company policies. Make sure the information that is needed is readily available and easily accessible.
- **Chain of command**: The maintenance of an organization's hierarchy is essential, but its very presence can reduce the flow of communication. To counteract that tendency, it's important to reduce unnecessary hierarchical levels and increase departmental interaction and communication.
- **Lack of trust**: In companies with a competition-driven culture, there may be a lack of trust among employees, which can hamper communication. Companies should strive to involve their employees in decisions, emphasize the importance of sharing information, and communicate openly and honestly.
- **Physical barriers or disabilities:** Hearing, vision, or speech problems can make communication challenging. Organizations need to be aware of accessibility issues for both internal and external communication.
- **Bias**: Preconceptions or prejudice can lead to stereotyping or false assumptions. Using care to choose unambiguous, neutral language and explain things clearly can help reduce bias.
- **Filtering:** People may hear what they expect to hear or want to hear, rather than what is said. Because filters are present in every system of communication, the message that the receiver receives is rarely the same as the one the sender sends. Some distortion of the message is almost inevitable.
- **Language and cultural differences:** Language use and social norms vary enormously from culture to culture. Companies need to educate themselves about cultural sensitivities and gear their messages to their audiences.

In the next section, we'll look more closely at the patterns and uses of business communication—who sends the messages, who receives them, and the different types of messages businesses typically use.

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11.5: Communication Channels, Flows, and Networks

What you'll learn to do: describe typical communication channels, flows, and networks within an organization, and explain when different channels are appropriate

In this section, we'll look more closely at the patterns of communication in business—who sends the messages, who receives them, and the different types of messages businesses typically use.

Learning Objectives

- Differentiate between appropriate and inappropriate uses of different communication channels
- Differentiate between formal and informal communication networks

Communication Channels

In communications, a channel is the means of passing information from a sender to a recipient. Determining the most appropriate channel, or medium, is critical to the effectiveness of communication. Channels include oral means such as telephone calls and presentations, and written modes such as reports, memos, and email.

Communication channels differ along a scale from rich to lean. Think about how you would select a steak—some have more fat than others; they are **rich** and full of flavor and body. If, however, you are on a diet and just want the meat, you will select a **lean** steak. Communication channels are the similar: rich channels are more interactive, provide opportunities for two-way communication, and allow both the sender and receiver to read the nonverbal messages. The leanest channels, on the other hand, trim the "fat" and present information without allowing for immediate interaction, and they often convey "just the facts." The main channels of communication are grouped below from richest to leanest:

- Richest channels: face-to-face meeting; in-person oral presentation
- Rich channels: online meeting; video conference
- Lean channels: teleconference; phone call; voice message; video (e.g., Facetime)
- Leanest channels: blog; report; brochure; newsletter; flier; email; phone text; social media posts (e.g., Twitter, Facebook)

Bill Gates speaking at a school. A speaker giving a large presentation is an example of oral communication.

Oral communications tend to be richer channels because information can be conveyed through speech as well as nonverbally through tone of voice and body language. Oral forms of communication can range from a casual conversation with a colleague to a formal presentation in front of many employees. Richer channels are well suited to complex (or potentially unsettling) information, since they can provide opportunities to clarify meaning, reiterate information, and display emotions.

While written communication does not have the advantage of immediacy and interaction, it can be the most effective means of conveying large amounts of information. Written communication is an effective channel when context, supporting data, and detailed explanations are necessary to inform or persuade others. One drawback to written communications is that they can be misunderstood or misinterpreted by an audience that doesn't have subsequent opportunities to ask clarifying questions or otherwise respond.

The following are some examples of different types of communication channels and their advantages:

- **Web-based communication**, such as video conferencing, allows people in different locations to hold interactive meetings. Other Web-based communication, such as information presented on a company Web site, is suited for sharing transaction details (such as order confirmation) or soliciting contact information (such as customer phone number and address)
- **Emails** provide instantaneous written communication; effective for formal notices and updates, as well as informal exchanges.
- **Letters** are a more formal method of written communication usually reserved for important messages such as proposals, inquiries, agreements, and recommendations.
- **Presentations** are usually oral and usually include an audiovisual component, like copies of reports, or material prepared in Microsoft PowerPoint or Adobe Flash.

- **Telephone meetings/conference calls** allow for long-distance interaction.
- **Message boards** and **Forums** allow people to instantly post information to a centralized location.
- **Face-to-face meetings** are personal, interactive exchanges that provide the richest communication and are still the preferred method of communication in business.

So, we have written and oral channels, channels that range from rich to lean, and then, within those, multiple channels from which the sender can choose. How do you decide the best channel for your message? When deciding which communication channel to use, the following are some of the important factors to consider:

- the audience and their reaction to the message;
- the length of time it will take to convey the information;
- the complexity of the message;
- the need for a permanent record of the communication;
- the degree to which the information is confidential; and
- the cost of the communication.

If you choose the wrong channel—that is, if the channel is not effective for the type of message and meaning you want to create—you are likely to generate misunderstanding and possibly end up making matters worse. Using the wrong channels can impede communication and can even create mistrust. For example, a manager wants to compliment an employee for his work on a recent project. She can use different approaches and channels to do this. She could send the an employee a text: "Hey, nice work on the project!" Or she could send him an email containing the same message. She could also stop by his desk and personally compliment him. She could also praise him in front of the whole department during a meeting. In each case the message is the same, but the different channels alter the way the message is perceived. If the employee spent months working on the project, getting a "Hey, nice work on the project!" text message or email might seem like thin praise—insulting even. If the employee is shy, being singled out for praise during a departmental meeting might be embarrassing. A face-to-face compliment during a private meeting might be received better. As you can see, getting the channel right is just as important as sending the right message.

Communication Flows

Communication within a business can involve different types of employees and different functional parts of an organization. These patterns of communication are called **flows**, and they are commonly classified according to the direction of interaction: downward, upward, horizontal, diagonal, external. As you learn about each of these, we will discuss how these flows function at Little Joe's Auto.

Downward Communication

When leaders and managers share information with lower-level employees, it's called **downward**, or **top-down communication**. In other words, communication from superiors to subordinates in a chain of command is a downward communication. This communication flow is used by the managers to transmit work-related information to the employees at lower levels. Ensuring effective downward communication isn't always easy. Differences in experience, knowledge, levels of authority, and status make it possible that the sender and recipient do not share the same assumptions or understanding of context, which can result in messages being misunderstood or misinterpreted. Creating clearly worded, unambiguous communications and maintaining a respectful tone can facilitate effective downward communication.

Little Joes's auto: downward communication

Little Joe holds a meeting every morning with his entire sales staff. In this meeting he gives them information on new cars on the lot, current interest rates available to customers, and how close they are to meeting the company's monthly sales goals. The most important information shared is a "hot sheet" that lists the cars that need to be sold ASAP because they have been on the lot for more than forty-five days. Every car sold from the hot sheet earns the salesperson a $500 bonus, adding more than a little motivation to the mix.

As Little Joe goes through his morning briefing, the sales staff listen, take notes, and sometimes ask a few clarifying questions, but clearly the purpose of this daily pow-wow is for Little Joe to convey the information his staff need to perform their jobs and meet the expectations of management.

Upward Communication

Upward communication is the transmission of information from lower levels of an organization to higher ones; the most common situation is employees communicating with managers. Managers who encourage upward communication foster cooperation, gain support, and reduce frustration among their employees. The content of such communication can include requests, estimations, proposals, complaints, appeals, reports, and any other information directed from subordinates to superiors. Upward communication is often made in response to downward communication; for instance, when employees answer a question from their manager. In this respect, upward communication is a good measure of whether a company's downward communication is effective.

The availability of communication channels affects employees' overall satisfaction with upward communication. For example, an open-door policy sends the signal to employees that the manager welcomes impromptu conversations and other communication. This is likely to make employees feel satisfied with their level of access to channels of upward communication and less apprehensive about communicating with their superiors. For management, upward communication is an important source of information that can inform business decisions. It helps to alert management of new developments, levels of performance, and other issues that may require their attention.

little joe's auto: upward communication

One afternoon, Frances knocks at Little Joe's office door, which is always open. Frances wants Little Joe to know that he has a couple interested in one of the new cars on the hot sheet, a 2015 Sonata, but the car is out of their price range by just a hair. Frances knows the couple from his church and really wants to help them get reliable transportation, but he also knows he needs to get the deal past the finance manager. Frances wants to know if it's possible for him to cut the price to his customers and give up his $500 bonus for selling the car. Little Joe agrees, since it really makes no difference who gets the $500—Frances or the customer.

Horizontal Communication

Horizontal communication, also called lateral communication, involves the flow of messages between individuals and groups on the same level of an organization, as opposed to up or down. Sharing information, solving problems, and collaborating horizontally is often more timely, direct, and efficient than up or down communication, since it occurs directly between people working in the same environment. Communication within a team is an example of horizontal communication; members coordinate tasks, work together, and resolve conflicts. Horizontal communication occurs formally in meetings, presentations, and formal electronic communication, and informally in other, more casual exchanges within the office.

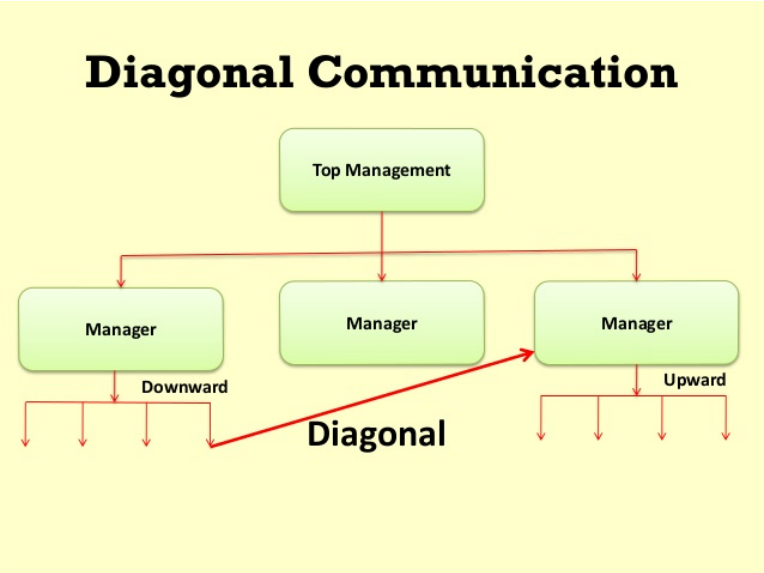
When there are differences in style, personality, or roles among coworkers, horizontal communication may not run smoothly. According to Professor Michael Papa, horizontal communication problems can occur because of territoriality, rivalry, specialization, and simple lack of motivation. Territoriality occurs when members of an organization regard other people's involvement in their area as inappropriate or unwelcome. Rivalry between individuals or teams can make people reluctant to cooperate and share information. Specialization is a problem that occurs when there is a lack of uniform knowledge or vocabulary within or between departments. Finally, horizontal communication often fails simply because organization members are unwilling to expend the additional effort needed to reach out beyond their immediate team.

little joe's auto: horizontal communication

Little Joe picks up his phone and calls Brian, the finance manager. He explains that Frances is going to send a deal through on a hot-sheet car that is $500 less than the bottom line, but if the rest of the deal is solid, Brian should approve it. Brian immediately begins to object, when Little Joe cuts him off and says that Frances is waiving his hot-sheet bonus. When Little Joe hangs up with Brian, he tells Frances he's set—now go sell that car!

Diagonal Communication

Diagonal communication is the sharing of information among different structural levels within a business. This kind of communication flow is increasingly the norm in organizations (in the same way that cross-functional teams are becoming more common), since it can maximize the efficiency of information exchange. The shortest distance between two points is a straight line. Diagonal communication routes are the straight lines that speed communications directly to their recipients, at the moment communication is necessary. Communications that zigzag along horizontal and vertical routes, on the other hand, are vulnerable to the schedules and availability of the individuals who reside at each level.



little joe's auto: diagonal communication

Frances returns to his customers and tells him he thinks he's got a way to make the deal work. Brian, the finance manager, approves the deal per his conversation with Little Joe, so all that's left is the final inspection in the service department. The customers have told Frances they need to be home by 3 pm, but when Frances sees the time and looks over at the line of cars waiting for final inspection, his stomach drops. There's no way he is going to get them out of the dealership by three, and he's afraid he'll lose the sale. He heads over to the service department to find Marcie, the service manager. He finds her in one of the service bays and explains his situation, asking if there's any way his customer can be moved ahead in the line. Marcie checks her clipboard, does some quick calculations, and calls over one of the service techs. She tells him to locate the 2015 Sonata and get it up on the lift next. Smiling, she turns to Frances and says, "Mission accomplished."

External Communication

Another type of communication flow is **external**, when an organization communicates with people or organizations outside the business. Recipients of external communication include customers, lawmakers, suppliers, and other community stakeholders. External communication is often handled by marketing and sales. Annual reports, press releases, product promotions, financial reports are all examples of external communication.

little joe's auto: external communication

The last thing Frances does before he hands the keys to his customers is to affix a Little Joe's Auto license plate frame to the front and back of the Sonata. Now everyone who sees his customers driving their new car will know where they bought it. He hopes this sale will generate more business for himself and the dealership, so along with the keys to the car, he gives them several business cards and a coupon for a free oil change. At 2:30, Frances waves good-bye to his customers as they drive their new Sonata off the lot.

In order to close this deal, the communication at Little Joe's Auto has flowed in every direction—upward, downward, horizontally, diagonally, and externally.

Communication Networks

By now you know that business communication can take different forms and flow between different kinds of senders and receivers. Another way to classify communication is by network.

An organization's **formal communication network** is comprised of all the communication that runs along its official lines of authority. In other words, the formal network follows reporting relationships. As you might expect, when a manager sends an email to her sales team describing the new commission structure for the next set of sales targets, that email (an example of downward communication) is being sent along the company's formal network that connects managers to their subordinates.

An **informal communication network**, on the other hand, doesn't follow authority lines and is established around the social affiliation of members of an organization. Such networks are also described as "grapevine communication." They may come into being through the rumor mill, social networking, graffiti, spoof newsletters, and spontaneous water-cooler conversations.

Informal versus Formal Networks

- Formal communication follows practices shaped by hierarchy, technology systems, and official policy.
- Formal communication usually involves documentation, while informal communication usually leaves no recorded trace for others to find or share.
- Formal communications in traditional organizations are frequently "one-way": They are initiated by management and received by employees.
- Formal Communication content is perceived as authoritative because it originates from the highest levels of the company.
- Informal communication occurs in any direction and takes place between individuals of different status and roles.
- Informal communication frequently crosses boundaries within an organization and is commonly separate from work flows. That is, it often occurs between people who do not work together directly but share an affiliation or a common interest in the organization's activities and/or a motivation to perform their jobs well.
- Informal communication occurs outside an organization's established channels for conveying messages and transmitting information.

In the past, many organizations considered informal communication (generally associated with interpersonal, horizontal communication) a hindrance to effective organizational performance and tried to stamp it out. This is no longer the case. The maintenance of personal networks and social relationships through information communication is understood to be a key factor in how people get work done. It might surprise you to know that 75 percent of all organizations' practices, policies, and procedures are shared through grapevine communication.[1]

While informal communication is important to an organization, it also may have disadvantages. When it takes the form of a “rumor mill” spreading misinformation, informal communication is harmful and difficult to shut down because its sources cannot be identified by management. Casual conversations are often spontaneous, and participants may make incorrect statements or promulgate inaccurate information. Less accountability is expected from informal communications, which can cause people to be indiscreet, careless in their choice of words, or disclose sensitive information.

1. Keith Davis, "Grapevine Communication Among Lower and Middle Managers," Personnal Journal, April, 1969, p. 272. ↵

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11.6: Electronic Communication

What you'll learn to do: identify common risks and ethical issues associated with electronic communication in business

In this section we'll touch on some of the risks and ethical issues business face when they rely on electronic communication.

Electronic Communication

- Identify common ethical issues associated with electronic communication in business

Electronic Communication

Starting in the 1980s with the development of information and communications technologies, businesses have increasingly come to rely on electronic channels as a primary means of communicating and of conducting business. Such technological advances have been a tremendous boon, as businesses are now able to transmit and store vast amounts of information cheaply and quickly. At the same time, these developments are not without risks or challenges, particularly where ethics and security are concerned. In this section we discuss some of the concerns surrounding the use of electronic communication technologies.

Risks of Electronic Communication

Electronic communication and eCommerce have presented businesses with exciting opportunities that couldn't have existed even a couple decades ago. At the same time, they've brought unexpected challenges. When businesses allow customers to shop online, receive discounts by providing personal information, use live chat to communicate with customer service, they are hoping to enhance their image and provide a customer experience that is superior to the competition. But, what happens when the information a customer shares with a business is compromised or stolen by a third party? Consider what Home Depot endured when their customer database was breached in 2014:

Data security is on everyone's mind these days, and the ways that electronic communication can be compromised seem to evolve as quickly as the technology. The following are just a few of the illicit and illegal ways that people get their hands on electronic communications:

- **Viruses, worms, and Trojan horses**. A computer virus is a type of malicious software program ("malware") that, when executed, replicates by reproducing itself (copying its own source code) or infecting other computer programs by modifying them. A computer worm is a stand-alone malware computer program that replicates itself in order to spread to other computers.

A Trojan horse, or Trojan, is any malicious computer program that is used to hack into a computer by misleading users about its true intent.

- **Spoofing or phishing.** Phishing is the attempt to obtain sensitive information such as usernames, passwords, and credit card details (and, indirectly, money), often for malicious reasons. Often the sender of the electronic communication is disguised as a trustworthy entity.
- **Denial-of-service attacks**. A denial-of-service attack (DoS attack) is a cyber attack in which the perpetrator seeks to make a machine or network resource unavailable to its intended users by temporarily or indefinitely disrupting the services of a host connected to the Internet.

The low cost and rapid delivery of electronic communication makes it the preferred method of communication for both business and consumers, but there can be hidden hazards and costs. The following are common ones:

- **Electronic communications are forever.** Electronic messages are permanent (this includes communications such as email and also audio recordings such as voice mail). Even if a person deletes the communications from his or her own server or account, there are generally other servers that still hold this information. One way that these types of communications live in perpetuity is when they are sent or forwarded to multiple individuals.
- **Someone may be watching.** In many cases, confidential information is leaked by someone else sifting through his or her messages. The culprit may be a disgruntled employee or even a competitor. Workstations left unattended, employees remaining logged on to networks and email accounts when they are away from their desk, and even sharing passwords with coworkers all make it easy for prying eyes to see information not intended to be shared.
- **Innocent messages can still harm you**. Civil litigation lawyers will warn you that even innocent messages can get you in trouble you if they are taken out of context. When a person writes an email or text, he or she may have only one intent or meaning in mind. However, messages can be misconstrued to apply to a completely different scenario.
- **Email avalanche**. Managers, in particular, are vulnerable to relying on email too heavily for communication. People use email because it's quick and easy, and they can send the same information to a lot of people at the same time. This can lead to information overload and misunderstandings by recipients, however. Words alone account for only 7 percent of communication, [1] so it's important for managers to be aware of the limitations of email in getting their messages across.

Ethical Issues in Electronic Communication

Technology enables businesses to communicate and store information more readily and efficiently than ever. However, as much as technology impacts the way that companies do business, it also raises important new issues for the employer-employee relationship. If you send personal emails from your office computer, do you have the right to expect that they're private? Does your employer have a legal and ethical right to "cyber-peek" at what you are doing with company assets? Twenty years ago this was not an issue; in 2010, it was a case before the Supreme Court. The case concerned the extent to which the right to privacy applies to electronic communications in a government workplace, and the city narrowly won. The U.S. Supreme Court has generally found in favor of employers, giving them the right to monitor any communication that occurs on their equipment (computers, smartphones, or pagers).

Employers want to use technology to help them screen applicants and verify information about their workforce, which is understandable. In the module on Human Resource Management you learned about the cost of recruiting, hiring, and training employees. However, what if the company believes that one of the quickest ways to gather information about an employee is to access their social media accounts? A company would never ask for your login credentials for Facebook, Twitter, Instagram, LinkdIn . . . or would they? And if they did, is it legally and ethically justified? What would you do if you found yourself in the situation presented in the following video?

The fact is that technology has put our information at the fingertips of businesses—there for the taking and, in some cases, the selling. Is it ethical for a business to collect data about a person and then sell that information to another business? Many organizations collect data for their own purposes, but they also realize that your data has value to others. As a result, selling data has become an income stream for many organizations. If you didn't realize that your data was collected by Company A, it's even less likely you knew that it was sold to Company B.

1. Mehrabian, Albert (1981). Silent Messages: Implicit Communication of Emotions and Attitudes (2nd ed.). Belmont, CA: Wadsworth. ↵

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11.7: Putting It Together- Teamwork and Communication

Synthesis

What did it take for these eight people to jump out of a perfectly good airplane and join hands to form a figure eight? Yes, nerves of steel and a measure of pure insanity. But it also took something else—the very thing you learned about in this module: teamwork and communication. As for these skydivers, the consequences of poor teamwork and faulty communication can be serious and even deadly. Defective parts can wind up in automobiles and airplanes, the wrong medications can be given to patients in a hospital, food can be contaminated . . . all as a result of poor teamwork and communication. Understanding the ways in which people communicate and overcome potential barriers can help you be a more effective communicator and a better team member. Moreover, the skills you've learned in this module are not only important in business—they're useful in skydiving and life.

Summary

In this module you learned about the importance of teamwork and communication in business. Below is a summary of the key points that were covered.

Teams

Teams are groups of individuals with complementary skills who come together to achieve a specific goal. Teams can be manager-led, self-directed, cross-functional, or even virtual. Companies use teams because they are an effective means of achieving objectives, and they bring increased efficiency to operations.

Team Development and Success

When teams are formed they evolve from individuals into a cohesive unit. The stages of team development are forming, storming, norming, performing, and adjourning.

What differentiates a successful team from an unsuccessful one? Some of the hallmarks of successful teams are the following: the members trust one another, common goals, defined team roles and responsibilities, good communication, and group cohesion.

Effective Communication and Barriers

Effective communications are thoughtful, clear, specific, brief, and timely. "Getting one's message across" can be tricky and challenging due to barriers that impede communication. Among the barriers to effective communication are filtering, bias, jargon, language and cultural differences, the chain of command, physical disabilities, and lack of trust.

Communication Channels, Flows, and Networks

Communication involves a sender, a message, and a receiver. The form a message takes is called a channel. Communication can occur between different kinds of senders and receivers within (and outside of) an organization. Communication can flow upward, downward, horizontally, diagonally, and externally. It can also flow through different networks, both informal and informal.

Electronic Communication

The rise of information technology that makes business communication faster and more efficient brings unique ethical challenges and risks. Businesses must take steps to keep employee and customer data safe; they must also establish security measures to protect against cyber threats such as malware, hacking, and theft.

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CHAPTER OVERVIEW

12: Managing Process

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12.1: Why It Matters- Managing Process

Why explain how operations management contributes to organizational success?

Operations management is just what it sounds like: managing the operations of the business. The role of an operations manager is broad and encompasses multiple operational areas. While other employees can focus on a specialized area of operation (for example, finance and marketing), an operations manager wears many hats and does a bit of everything. While the term may be unfamiliar, you have probably already seen operations management in action—it even played a role in creating the beautiful turkey dinner in the photo below.

What does it take to make Thanksgiving dinner happen? Planning, scheduling, technology, logistics, supply chain management, quality assurance—all the aspects of operations management. As an overview to this module, let's take Turkey Day as an example:

- *Planning*. Turkey dinner for fifteen people doesn't just happen. It takes careful planning and possibly the delegation of tasks and duties to others. Who sets the table? Who brings the green bean casserole? What time should everyone arrive?
- *Scheduling*. A turkey can take up to six hours to cook, and if you have only one oven, you'll need to schedule what time the bird goes in and comes out so the rolls and sweet potatoes get a turn in the oven.
- *Technology*. Obviously you'll need an oven (or maybe a high-tech turkey fryer) and any number of cooking gadgets. Even the humble thermometer counts as technology. Unless you're preparing a raw, paleo Thanksgiving dinner, technology will be essential.
- *Logistics*. Fifteen people won't all fit around your current table. What should you do? Seat the children at a card table? Rent a larger table? And where should Uncle Stanley sit so he can't pick a fight with your spouse or your dad? Logistics, logistics.
- *Supply Chain Management.* Aunt Sue is bringing pies, Bob is responsible for rolls, Margaret is bringing the green beans. The host has to secure a fresh turkey before they sell out at the grocery store. If you live in the South, then you'll want to call the local fisherman and reserve some oysters for the oyster dressing. All are important components of the supply chain—leave one out and you'll miss a dish.
- *Quality Assurance.* Anyone who cooks knows you need to taste, season, and taste again to make sure the food is up to snuff. Quality assurance might also include asking Jean to bring drinks and flowers, since she's a terrible cook.

Any undertaking that involves the coordination of effort, tasks, and resources can be considered operations management. In this module you'll learn how operations management works in both manufacturing and service industries—in short, you'll see how others get their turkey on the table.

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12.2: Operations Management

What you'll learn to do: explain operations management in the production of goods and services

In this section you'll get an introduction to the key concepts and functions of operations management.

Learning Objectives

- Explain the role of the operations manager
- Explain how operations management relates to the service industry

Operations Management

It's one thing to be in charge of getting Thanksgiving dinner on the table, but it's another to manage a complex manufacturing process. Before we explore what's involved in such an undertaking, let's begin our study of processes and operations by defining some key terms you will use throughout this module.

Operations management is the area of management concerned with designing and controlling the processes of producing goods and services. It involves ensuring that business operations are efficient in terms of using as few resources as needed and effective in terms of meeting customer requirements. Put differently, operations management is concerned with managing the process that converts inputs (in the forms of raw materials, labor, and energy) into outputs (in the form of goods and/or services). That process can be as simple as milling trees into lumber or as complex as building an international space station.

An **operations manager** is in charge of making sure that production processes run smoothly. That includes fine-tuning production processes to ensure quality, holding down the costs of materials and labor, and cutting costs that don't add value to the finished product. As you might expect, the role of an operations manager is broad, encompassing many operational areas. While other managers may focus on a specific area, such as finance, accounting, or human resources, an operations manager interacts with every functional area within the organization. This is because operations management includes so many different kinds of tasks—logistics, budgeting, supplier relations, purchasing, staffing, and many more. As globalization has increased competition, the operations manager's job responsibilities have increased in both scope and importance.

Operations Management in the Service Industry

In businesses that produce services, the need for operations management may seem less obvious, since they don't produce tangible goods. Operations management is all about transformation, though—taking inputs and transforming them into outputs—and it involves things like suppliers, supply chains, and logistics. All of these things are present in service industries. Consider how "operations" play out in a service business—let's say in a theme park like Wally World. Although the company doesn't manufacture products, it is still producing an experience. The following breakdown gives you an idea of how and why operations management is so important to this kind of business:

- How do you control the crowds? How many guests should be let into the park before the line to ride the Tea Cups is intolerably long?
- How many cars should be attached to the Cyclone of Doom rollercoaster to maximize the number of riders but still ensure their safety and security?
- For July 4th weekend, how many tons of ice cream need to be ordered to supply all the ice-cream carts and keep all the hot, tired, and hungry patrons happy?
- Where do you purchase the park's supplies? That's everything from souvenir cups with Wally's picture on them to paper plates and napkins for the restaurants.
- How do you staff entrances and exits? How much security is enough to let guests feel comfortable letting their children roam around?

How do you manage the operations of this type of business that produces fun as its primary product? Answer: You hire an operations manager!

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12.3: Production Processes

What you'll learn to do: describe the four main categories of production processes

Even though you may not spend a lot of time thinking about the processes used to make different products, they surround you every day. Every time you come in your front door or eat a meal or even drive your car, you interact with things that were made by combinations of job-based, batch, mass, and flow production processes: they were all produced or manufactured by someone, somewhere, and a great deal of thought and planning were needed to make them available.

Businesses know what they want to produce, but the challenge is to select a process that will maximize the productivity and efficiency of production. Senior management looks to their operations managers to inform this decision. As we examine the four major types of production processes, keep in mind that the most successful organizations are those that have their process and product aligned.

Learning Objectives

- Describe batch production
- Describe mass production

Project- or Job-Based Production

Project-based production is one-of-a-kind production in which only one unit is manufactured at a time. This type of production is often used for very large projects or for individual customers. Because the customer's needs and preferences play such a decisive role in the final output, it's essential for the operations manager to maintain open and frequent communication with that customer. The workers involved in this type of production are highly skilled or specialists in their field.

The following are examples of project- or job-based production:

- custom home construction
- haircuts
- yachts

Consider the home in which you live. When the house was built, the contractor used a job process, and highly skilled workers were brought in to install the plumbing, heating, and electrical systems.

custom prints

For example, a print shop may handle a variety of projects, including newsletters, brochures, stationery, and reports. Each print job varies in quantity, type of printing process, binding, color of ink, and type of paper. A manufacturing firm that produces goods in response to customer orders is called a job shop.

Some types of service businesses also deliver customized services. Doctors, for instance, must consider the illnesses and circumstances of each individual patient before developing a customized treatment plan. Real estate agents may develop a customized service plan for each customer based on the type of house the person is selling or wants to buy.

Advantages

- Unique, high quality products are made.
- Workers are often more motivated and take pride in their work.
- Products are made according to individual customer needs and improve customer satisfaction
- Production is easy to organize

Disadvantages

- Very labour intensive, so selling prices are usually higher.
- Production can take a long time and can have higher production cost, (e.g., if special materials or tools are required)

Batch Production

Batch production is a method used to produce similar items in groups, stage by stage. In batch production, the product goes through each stage of the process together before moving on to the next stage. The degree to which workers are involved in this type of production depends on the type of product. It is common for machinery to be used for the actual production and workers participate only at the beginning and end of the process.

Examples of batch production include the following:

- bakeries
- textiles
- furniture

Example 12.3.1

American Leather, a Dallas-based furniture manufacturer, uses mass customization to produce couches and chairs to customer specifications within 30 days. The basic frames in the furniture are the same, but automated cutting machinery precuts the color and type of leather ordered by each customer. Using mass-production techniques, they are then added to each frame.

Advantages

- Since larger numbers are made, unit costs are lower.
- Offers the customer some variety and choice.
- Materials can be bought in bulk, so they are cheap.
- Production is flexible since different batches are made
- Workers specialize in one process

Disadvantages

- Workers are often less motivated because the work becomes repetitive.
- Initial set-up costs are high.
- Expensive to move products around the workplace.
- Storage space will be needed to store raw materials.

Mass Production

Mass production, manufacturing many identical goods at once, was a product of the Industrial Revolution. Henry Ford's Model-T automobile is a good example of early mass production. Each car turned out by Ford's factory was identical, right down to its color. If you wanted a car in any color except black, you were out of luck. Canned goods, over-the-counter drugs, and household appliances are other examples of goods that are mass-produced. The emphasis in mass production is on keeping manufacturing costs low by producing uniform products using repetitive and standardized processes. As products became more complicated to produce, mass production also became more complex. Automobile manufacturers, for example, must now incorporate more sophisticated electronics into their car designs. As a result, the number of assembly stations in most automobile manufacturing plants has increased.

peeps

Watch the following video on the process used to manufacture the amazing Peep. It will serve as a point of reference because it features many of the process components we will be discussing in this reading.

Advantages

- Labour costs are usually lower
- Materials can be purchased in large quantities, so they are often cheaper
- Large number of goods are produced
- Unit costs are relatively low

Disadvantages

- Machinery is very expensive to buy, so production lines are very expensive to set up.
- Workers are not very motivated, since their work is very repetitive.
- Not very flexible, as a production line is difficult to adapt.
- If one part of the line breaks, the whole production process will have to stop until it is repaired.delay the production process
- Maintenance cost are very high

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12.4: Production Planning

What you'll learn to do: explain the components involved in planning and scheduling the production process

Production doesn't happen by magic. Think about hosting a large party for your parents' anniversary. The first thing you have to do is find a location that is large enough to accommodate all the people you will be inviting. Once you have identified the location, you then need to visit the site and decide how it will be laid out. Where should the tables and chairs go, where will you set up refreshments, and what about a gift table? Once you've decided on the layout, then you need to start making a list of the materials you'll need for the party. This includes everything from plates, cups, and napkins to hiring a DJ and a caterer. Lastly, based on the number of guests, you'll need to calculate how much of everything—food, drinks, etc.—to order.

Operations managers engage in similar planning, but they use different terminology to describe the different parts of the plan. In production planning, the components are facility location, facility layout, materials-requirement planning (MRP), and inventory control.

Learning Objectives

- Explain facility layout
- Explain just-in-time inventory control (JIT)
- Differentiate between Gantt charts, PERT, and the critical path method

Facility Location and Layout

Facility Location

Of all the pieces of the planning puzzle, facility location is the most strategic and critical. Once you build a new manufacturing facility, you have made a substantial investment of time, resources, and capital that can't be changed for a long time. Selecting the wrong location can be disastrous. Some of the key factors that influence facility location are the following:

- Proximity to customers, suppliers, and skilled labor
- Environmental regulations
- Financial incentives offered by state and local development authorities
- Quality-of-life considerations
- Potential for future expansion

The next step, after planning the production process, is deciding on plant layout—how equipment, machinery, and people will be arranged to make the production process as efficient as possible.

Facility Layout

The primary aim of facility layout is to design a workflow that maximizes worker and production efficiency. Facility layout is complex because it must take into account the available space, the work processes, the delivery of components and parts, the final product, worker safety, and operational efficiency. A poorly laid-out production facility creates inefficiencies, increases costs, and leads to employee frustration and confusion.

The four most common types of facility layout are process, product, cellular, and fixed position.

Process Layout

A **process layout** aims to improve efficiency by arranging equipment according to its function. Ideally, the production line should be designed to eliminate waste in material flows, inventory handling, and management. In process layout, the work stations and machinery are not arranged according to the production sequence. Instead, there is an assembly of similar operations or similar machinery in each department (for example, a drill department, a paint department, etc.)

Product Layout

In a **product layout**, high-volume goods are produced efficiently by people, equipment, or departments arranged in an assembly line—that is, a series of workstations at which already-made parts are assembled.

In the following video, Jansen, a Swiss steel maker, describes how the company's offices were designed to maximize the productivity and creativity of its engineers:

Cellular Layout

A **cellular layout** is a lean method of producing similar products using cells, or groups of team members, workstations, or equipment, to facilitate operations by eliminating set-up and unnecessary costs between operations. Cells might be designed for a specific process, part, or a complete product. The goal of cellular manufacturing is to move as quickly as possible and make a wide variety of similar products with as little waste as possible. This type of layout is well suited for single-piece and one-touch production methods. Because of increased speed and minimal handling of materials, cells can result in great cost and time savings and reduced inventory.

Fixed Position

It is easy to move marshmallow candies around the factory while you are making them, but what about airplanes or ships? For the production of large items, manufacturers use **fixed-position layout** in which the product stays in one place and the workers (and equipment) go to the product. To see an excellent example of fixed-position layout, watch the following video that shows how Boeing builds an airplane.

Materials Planning and Inventory Control

After the facility location has been selected and the best layout has been determined, the next stage in production planning is to determine our material requirements.

Material-Requirements Planning (MRP)

Material-requirements planning (MRP) is a production planning, scheduling, and inventory control system used to manage manufacturing processes. Most MRP systems are software-based, but it is possible to do MRP by hand, as well.

An MRP system is intended to meet the following objectives simultaneously:

- Ensure that materials are available for production and products are available for delivery to customers
- Maintain the lowest possible material and product levels in store
- Plan manufacturing activities, delivery schedules, and purchasing activities

Some manufacturing firms have moved beyond MRP systems and are now using enterprise resource planning (ERP) systems. ERP systems provides an integrated and continuously updated view of core business processes using shared databases maintained by a database management system. ERP systems track business resources—cash, raw materials, production capacity—and the status of business commitments—orders, purchase orders, and payroll. The applications that make up the system share data from and between various departments (e.g., manufacturing, purchasing, sales, accounting, etc.). ERP facilitates information flow between all business functions and manages connections to outside stakeholders.

Even with the implementation of highly integrated planning software, operations managers still need to plan for and control inventory.

Just-in-Time (JIT) Manufacturing

Just-in-time (JIT) manufacturing is strategy that companies employ to increase efficiency and decrease waste by receiving goods only when they are needed in the production process, thereby reducing inventory costs. In theory, a JIT system would have parts and materials arriving on the warehouse dock at the exact moment they are needed in the production process. To make this happen, manufacturers and suppliers must work together closely to prevent just-in-time from becoming just-isn't-there. Operations managers must accurately forecast the need for materials, since even the slightest deviation can result in a slowdown of production.

Scheduling Tools

Izmailovo Hotel complex, Moscow, Russia

As you might expect, operations managers find that complex processes involve complex planning and scheduling. Consider the Izmailovo Hotel in Moscow shown in the photograph at the right. Built to house athletes during the 1980 Olympics, the complex has 7,500 guest rooms and is the largest hotel in the world. Think about cleaning all those rooms—in four thirty-story-high towers—or checking in the thousands of guests. No small operation! Although the Izmailovo doesn't produce a tangible good, it relies on many of the same operations management principles used in manufacturing to stay in business. To increase operational efficiency in complex processes like those of

running a giant hotel, operations managers use three common planning tools: Gantt charts, PERT, and the critical path method (CPM).

Gantt Charts

A Gantt chart is a timeline. Multiple projects can be added to the timeline with start and finish dates, and milestones and deadlines are also reflected. This chart is used to determine how long a project will take, the resources needed, and the order in which tasks need to be completed.

Let's look at a Gantt chart for producing a birdhouse. Suppose the following activities are required to build and package each birdhouse:

1. Determine which birdhouse the customer has ordered
2. Trace pattern onto wood
3. Cut the pieces of wood from the birdhouse pattern
4. Assemble the pieces into a birdhouse
5. Paint birdhouse
6. Attach decorations to the birdhouse
7. Prepare a shipping carton
8. Pack birdhouse into shipping carton
9. Prepare customer invoice
10. Prepare packing slip and shipping label
11. Deliver carton to shipping department

Below is the corresponding Gantt chart:

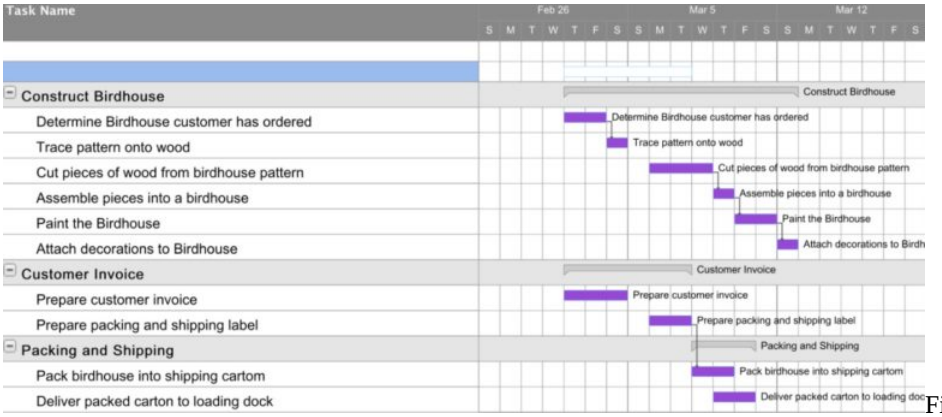


Figure 12.4.1. Gantt Chart

As you can see, the tasks on the list are displayed against time. On the left of the chart are all the tasks, and along the top is the time scale. A bar represents each work task; the position and length of the bar indicate the start date, duration, and end date of the task. At a glance, we can determine the following:

- What the various activities are
- When each activity begins and ends
- How long each activity lasts
- Where activities overlap with other ones, and by how much
- The start and end date of the whole project

PERT

Gantt charts are useful when the production process is simple and the activities are not interdependent. For more complex schedules, operations managers use PERT, which stands for "program evaluation and review technique." This is a method of analyzing the tasks involved in completing a given project, especially the time needed to complete each task and to identify the minimum time needed to complete the total project. PERT was developed primarily to simplify the planning and scheduling of large and complex projects. The key to this technique is that it organizes activities in the most efficient sequence. It can also help managers determine the critical path, which is discussed below.

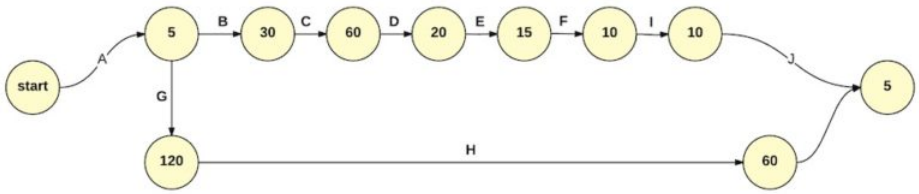
Critical Path Method (CPM)

The critical path method (CPM) is a step-by-step technique for process planning that identifies critical and noncritical tasks in order to prevent time-frame problems and process bottlenecks. The CPM is ideally suited to operations consisting of numerous activities that interact in a complex manner. It's often used in conjunction with PERT.

The essential technique for using CPM is to construct a model of the project that includes the following:

1. A list of all activities needed to complete the project
2. The time that each activity will take to complete,
3. The dependencies between the activities and,
4. Logical end points such as milestones or deliverable items.

Using these values, CPM calculates the longest path of planned activities (expressed in time) to logical end points or to the end of the project, and the earliest and latest that each activity can start and finish without making the project longer. This process determines which activities are "critical" (i.e., on the longest path) and which can be delayed without extending the overall project duration. Take a look at Figure 2, below. What was the critical path in our construction of a birdhouse?



Index	Activity Description	Required Predecessor	Duration (minutes)
A	Determine Birdhouse	(none)	5
B	Trace Pattern	A	30
C	Cut Pieces	A, B	60
D	Assemble Pieces	A, B, C	20
E	Paint	A, B, C, D	15
F	Decorate	A, B, C, D, E	10
G	Invoice	A	120
H	Packing & Shipping Label	G	60
I	Pack Birdhouse	A, B, C, D, E, F	10
J	Carton to Loading Dock	I	5

Figure 12.4.2 Critical Path

Our critical path was the path that took the longest amount of time! This was sequence of activities that included the customer invoice and packing and shipping label (from the start to G to H), which totaled 180 minutes. The problem is that even if we were able to assemble and decorate the birdhouse faster, the birdhouse would just and wait for the paperwork to be completed. In other words, we can gain efficiency only by improving our performance in one or more of the activities along the critical path.

did you know...?

PERT was developed by the U.S. Navy. The Navy's Special Projects Office devised this statistical technique for measuring and forecasting progress while they were designing the Polaris-Submarine weapon system and the Fleet Ballistic Missile capability.

CPM was first used for major skyscraper development in 1966 for the construction of the former World Trade Center Twin Towers in New York City.[1]

1. Kerzner, Harold (2003). Project Management: A Systems Approach to Planning, Scheduling, and Controlling (8th ed.) ↵

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12.5: New Technologies

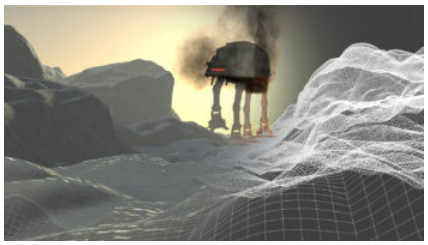
What you'll learn to do: identify existing and emerging technologies that are changing the way goods are produced and delivered

Technology has revolutionized the way products are manufactured and delivered. In this section you'll get a glimpse of some of the latest technological innovations and see how they're changing business operations.

Learning Objectives

- Describe CAM
- Describe flexible manufacturing

New Technologies



With certain kinds of manufacturing processes—especially ones demanding high precision and mass production—it can be difficult or too costly to find the skilled labor needed to perform the tasks. This pressure has led to a growing reliance on computers and highly specialized software systems. Some of these new, sophisticated technologies are described below.

Computer-Aided Design

Computer-aided design (CAD) is the use of computer systems (or workstations) to aid in the creation, modification, analysis, or optimization of a design. CAD software is used to increase the productivity of the designer, improve the quality of design, improve communications through documentation, and to create a database for manufacturing. CAD is an important industrial art extensively used in many applications, including automotive, shipbuilding, and aerospace industries, industrial and architectural design, prosthetics, and many more. CAD is also widely used to produce computer animation for special effects in movies, advertising, and technical manuals. The ubiquity and power of computers today means that even perfume bottles and shampoo dispensers are designed using techniques unheard of by the engineers of the last century.

Computer-Aided Manufacturing

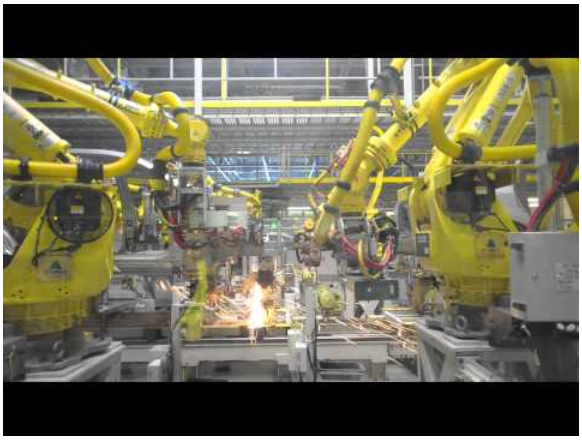
Computer-aided manufacturing (CAM) is the use of software to control machine tools in the manufacturing of workpieces. Its primary purpose is to speed the production process and produce components and tooling with more precise dimensions and material consistency. In some cases this enables production using only the required amount of raw materials—thus minimizing waste and reducing energy consumption.

In the following video, a CNC carving machine uses a computer program (CAD/CAM) to create an amazing woodcarving:

Computer-Integrated Manufacturing

Computer-integrated manufacturing (CIM) is a manufacturing approach that uses computers to control the entire production process. This integration allows individual processes to exchange information with one another and initiate actions. Although CIM can be faster and less error prone than conventional manufacturing, the main advantage is the ability to create automated manufacturing processes.

Watch this short video of a factory in which CIM is used in the factory production line to build the Kia Sportage:



Flexible Manufacturing Systems

A **flexible manufacturing system (FMS)** offers flexibility in the way the production system reacts to changes, whether planned or unplanned. This flexibility is typically built into one of the following:

- **Machine flexibility:** the system can be changed to produce new product types or alter the order of operations executed on a part.
- **Routing flexibility:** the system has multiple machines that can perform the same operation on a part, or the system can absorb large-scale changes in volume, capacity, or capability.

An FMS has immense advantages over traditional production lines in which machines are set up to produce only one type of good. When the firm needs to switch a production line to manufacture a new product, substantial time and money are often spent modifying the equipment. An FMS makes it possible to change equipment set-ups merely by reprogramming computer-controlled machines. Such flexibility is particularly valuable to companies that produce customized products.

3D Printing

3D printing (or additive manufacturing, AM) is any of various processes used to make a three-dimensional object. In 3D printing, additive processes are used, in which successive layers of material are laid down under computer control. These objects can be of almost any shape or geometry, and are produced from a 3D model or other electronic data source. A 3D printer is a type of industrial robot. Several different 3D printing processes have been invented since the late 1970s. The printers were originally large, expensive, and highly limited in what they could produce; today they are much cheaper and more versatile.

The following short videos show 3D printing in action:

The main differences between 3D printing processes are in the way layers get deposited to create parts and in the materials used to produce those layers. Some methods melt or soften material to produce the layers, while others cure liquid materials using different sophisticated technologies. The primary considerations in choosing a 3D printer are speed, cost of the machine, cost of the printed prototype, cost and choice of materials, and color capabilities.

Regardless of the type of technology being used in the production process, consumers benefit greatly from these advances. Mass customization of everything from Yankee candles to T-shirts to beverage Koozies is possible because of these exciting advances in computer technology.

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12.6: Supply Chain Management Logistics

What you'll learn to do: explain the importance of supply chain management and logistics

In this section you'll learn about the role of supply chain management and logistics in the production of goods and services.

Learning Objectives

- Differentiate between supply chain management and logistics
- Differentiate between inbound and outbound logistics

Supply Chain Management and Logistics

The following video provides an overview of the importance of supply chain management and logistics.

Supply Chain Management

As you saw in the video, **supply chain management** is the process of managing the movement of the raw materials and parts from the beginning of production through delivery to the consumer. In many organizations, operational supply chain decisions are made hundreds of times each day affecting how products are developed, manufactured, moved, and sold. The complexity of the supply chain varies with the size of the business and the intricacy and quantity of items manufactured, but most supply chains have elements in common, such as the following:

- **Customers:** Customers start the chain of events when they decide to purchase a product that has been offered for sale by a company. If the product has to be manufactured, the sales order will include a requirement that needs to be fulfilled by the production facility.
- **Planning:** The planning department will create a production plan to produce the products to fulfill the customer's orders. To manufacture the products, the company will then have to purchase the raw materials needed.
- **Purchasing**: The purchasing department receives a list of raw materials and services required by the production department to complete the customers' orders.
- **Inventory:** The raw materials are received from the suppliers, checked for quality and accuracy, and moved into the warehouse.
- **Production:** Based on a production plan, the raw materials are moved to the production area. These raw materials are used to manufacture the finished products ordered by the customer and then sent to the warehouse where they await shipping.

- **Transportation:** When the finished product arrives in the warehouse, the shipping department determines the most efficient method to ship the products so they are delivered on or before the date specified by the customer.

Take a look at the following video about BYU ice-cream production. Can you identify each of the elements, above, in BYU's supply chain?

Logistics

When used in a business sense, logistics is the management of the flow of things between the point of origin and the point of consumption in order to meet requirements of customers or corporations. The resources managed in logistics can include physical items such as food, materials, animals, equipment, and liquids, as well as abstract items, such as time and information. The logistics of physical items usually involves the integration of information flow, material handling, production, packaging, inventory, transportation, and warehousing.

There is often confusion over the difference between logistics and supply chains. It is now generally accepted that logistics refers to activities within one company/organization related to the distribution of a product, whereas supply chain also encompasses manufacturing and procurement and therefore has a much broader focus, as it involves multiple enterprises, including suppliers, manufacturers, and retailers, working together to meet a customer's need for a product or service.

One way to look at business logistics is "having the right item in the right quantity at the right time at the right place for the right price in the right condition to the right customer." An operations manager who focuses on logistics will be concerned with issues such as inventory management, purchasing, transportation, warehousing, and the planning and organization of these activities. Logistics may have either an internal focus (inbound logistics) or an external focus (outbound logistics).

Inbound Logistics

A manager in charge of inbound logistics manages everything related to the incoming flow of resources that the company needs to produce its goods or services. These activities will include managing supplier relationships, accessing raw materials, negotiating materials pricing, and arranging quicker delivery.

Outbound Logistics

A manager working in outbound logistics will be focused on two issues: storage and transportation. He or she will use warehousing techniques to keep the finished goods safe and accessible. Since the products may need to be moved out to a customer at any moment, proper organization is crucial. Having as little product stored as possible can be advantageous since stored products are not making money, so the outbound logistics manager often has to balance company cost savings with consumer demand. The transportation function is by far the most complex part of outbound logistics. Without transport, there simply is no logistics. For that reason it's critical to be able to move the product from one location to another in the fastest, most cost-effective, and efficient way possible. Since transportation involves fluctuations, factors such as delays and changes in fuel costs need to be taken into account in order to cover all possible scenarios that might jeopardize the efficient movement of goods.

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12.7: Quality Assurance

What you'll learn to do: summarize common management techniques used to ensure high-quality goods and services

In this section you'll learn about common quality-management techniques used in the production of goods and services. We'll also discuss the role of national and international quality standards in industry.

Learning Objectives

- Explain the benefits of national and international quality standards in the production of goods and services

Quality Assurance

What is *quality*? According to the American Society for Quality, quality refers to "the characteristics of a product or service that bear on its ability to satisfy stated or implied needs."[1]

As a customer, you're constantly assured that when products and services make it to market, they're of the highest quality, and if they aren't—if they fail to meet your expectations or to live up to claims—you may decide to avoid certain brands or give up on those products/services altogether. When companies can't deliver quality goods or services, they risk losing trust, loyalty, and business.

Nowhere are the high stakes of quality more evident than in the case of a product recall—when a company requests the return of a product after the discovery of safety issues or product defects that might endanger the consumer.

Consider Samsung's recent recall on its popular tablet computer, the Galaxy Note7, in October 2016:

> *"Samsung has announced an expanded voluntary recall on all original and replacement Galaxy Note7 devices sold or exchanged in the United States in cooperation with the U.S. Consumer Product Safety Commission and in partnership with carriers and retailers. Since the affected devices can overheat and pose a safety risk, we are asking consumers with a Galaxy Note7 to power it down and contact the carrier or retail outlet where they purchased their device."*[2]

If you bought a Galaxy Note7, you probably weren't expecting that it might catch fire during regular use! If you held shares of Samsung in your stock portfolio, you probably weren't expecting that the company's stock price would plummet practically overnight, either. After all, Samsung was the number one manufacturer of smart phones in the world, and as of September 30, 2106, it had sold 2.5 million Galaxy Note7 devices worldwide. Yet this is exactly what happened. Besides affecting millions of customers and taking a toll on shareholders, the recall meant lost income for retailers, who had to pull the device from their shelves, and for many of Samsung's suppliers. The entire supply chain was impacted by this quality debacle.

Given the devastating financial and, in some cases, legal consequences of selling inferior goods or services, how do companies actually ensure that they're producing products and offering services that meet customer expectations for quality? We will examine just a few of the ways that companies manage the production of quality goods and services.

Statistical Process Control

Statistical process control (SPC) is a method of quality control that uses statistical or mathematical methods to monitor and control a process. The goal of SPC is to ensure that production operates at its full potential. "Full potential" indicates the point where the process produces as much conforming product as possible with a minimum (if not the total elimination) of defective parts, rework, or scrap. SPC can be applied to any process in which the product can be measured. Key tools used in SPC include control charts with a focus on continuous improvement.

Example 12.7.1

Margie is the production manager at Wanda's Widgets. The company uses SPC as their approach to quality assurance. Several times per day, the quality-assurance team comes to the production floor and takes a sample of widgets from the production line. These widgets are closely inspected to be certain that they meet the company standards. Everything from their weight to the uniformity of the paint is closely inspected and entered into the SPC software program. When the data are analyzed, if the output from the SPC software indicates that the widgets do not meet the standard, Margie is alerted that there is an issue, and production may be stopped until the process is producing as many perfect widgets as possible.

Benchmarking

Benchmarking involves comparing one's business processes and performance metrics to industry bests and best practices from other companies. Dimensions typically measured are quality, time, and cost. In the process of best-practice benchmarking, management identifies the best firms in their industry—or in another industry where similar processes exist—and compares the results and processes of those studied (the "targets") to one's own results and processes. In this way, management learn how well the targets perform and, more important, the business processes that explain why those firms are successful.

Benchmarking is used to measure performance using a specific indicator (cost per unit of measure, productivity per unit of measure, cycle time of x per unit of measure or defects per unit of measure) resulting in a metric of performance that is then compared to others. Benchmarking may be a one-time event but is often treated as a continuous process in which organizations continually seek to improve their practices.

Lean Manufacturing

The central idea of **lean manufacturing** is actually quite simple: Work relentlessly to eliminate waste from the manufacturing process. In this context, "waste" is defined as any activity that doesn't add value from the customer's perspective. Almost every company has a tremendous opportunity to improve by using lean manufacturing techniques. Lean principles were developed by the Japanese manufacturing industry—by Toyota and the Toyota Production System (TPS) specifically. Lean manufacturing is based on the following goals and assumptions:

- Continuous improvement
- Respect for people
- Long-term approach to process improvement
- The right process will product the right results
- Add value to the organization by developing your people and partners
- Continuously solving root problems

did you know...?

Toyota originally began sharing the TPS with its parts suppliers in the 1990s. Because of interest in the program from other organizations, Toyota began offering instruction in the methodology to others. Toyota has even "donated" its system to charities, providing its engineering staff and techniques to nonprofits in an effort to increase their efficiency and thus ability to serve people. For example, Toyota assisted the Food Bank For New York City to significantly decrease waiting times at soup kitchens, packing times at a food distribution center, and waiting times in a food pantry.[3]

Six Sigma

In the United States, another approach to quality management was formulated at Motorola in 1986 and was named **Six Sigma (6σ)**. Whereas lean management is focused on eliminating waste and ensuring efficiency, Six Sigma focuses on eliminating defects and reducing variability. The following features also set Six Sigma apart from other quality-improvement initiatives:

- A clear focus on achieving measurable and quantifiable financial returns from any Six Sigma project. To determine the financial return on a quality initiative, the cost of quality (COQ) must be calculated. The cost of quality has two parts, added together: the cost of prevention and the cost of failure (or nonconformance). If spending more on prevention reduces the cost of failure by an even greater amount, the total cost of quality is reduced, and such a project would make good business sense.
- An increased emphasis on strong and passionate management leadership and support.
- A clear commitment to making decisions on the basis of verifiable data and statistical methods, rather than on assumptions and guesswork.

Six Sigma identifies individuals considered to be "experts in quality," and it awards titles like Champion and Master Black Belt. By the late 1990s, about two-thirds of the top five hundred companies in the United States had begun Six Sigma projects, including Ford, which had allowed its quality programs to slip.

International Quality Standards

As a consumer, wouldn't you like to know which companies ensure that their products meet quality specifications? Or, might you want to know which companies take steps to protect the environment? Some consumers want to know which companies continuously improve their performance in both of these areas—that is, practice both quality management and environmental management. By the same token, if you were a company doing a good job in these areas, wouldn't you want potential customers to be aware of your achievements? It might also be worthwhile to find out whether your suppliers were being conscientious in these areas—and even your suppliers' suppliers.

ISO 9000 and ISO 14000

Through the International Organization for Standardization (ISO), a nongovernmental agency based in Switzerland, it's possible to find out the kind of information just mentioned. The resources of this organization will enable you to identify those organizations that have people and processes in place for delivering products that satisfy customers' quality requirements. You can also find out which organizations work to reduce the negative impact of their activities on the environment. Working with representatives from various countries, the organization has established the ISO 9000 family of international standards for quality management and the ISO 14000 family of international standards for environmental management.

ISO standards focus on the way a company does its work, not on its output (though there's certainly a strong correlation between the way in which a business functions and the quality of its products). Compliance with ISO standards is voluntary, and the certification process is time-consuming and complex. Even so, hundreds of thousands of organizations around the world are ISO 9000 and ISO 14000 certified.[4] ISO certification has become an internationally recognized symbol of quality management and is increasingly essential to being competitive in the global marketplace.

Malcolm Baldrige National Quality Award

To provide encouragement and a consistent standard, the U.S. government created the Malcolm Baldrige National Quality Award in 1987 to encourage companies to improve quality; the award was named for Malcolm Baldrige, who was the U.S. secretary of commerce from 1981 to 1987.[5] The Commerce Department's National Institute of Standards and Technology (NIST) manages the Baldrige Award in cooperation with the private sector. An organization may compete for the award in one of six categories: manufacturing, service, small business, health care, education, and nonprofit (including government agencies). An independent board of examiners recommends the Baldrige Award recipients after evaluating them in the following seven areas defined by the Baldrige Excellence Framework:

- leadership
- strategy
- customers
- measurement
- analysis and knowledge management
- workforce
- operations
- results

Past recipients of the Baldridge Award include the following:

- Price-Waterhouse-Coopers Public Sector Practice, McLean, VA
- Pewaukee School District, Pewaukee, WI
- Concordia Publishing House, St. Louis, MO
- City of Irving, Irving, TX
- Lockheed Martin Missiles and Fire Control, Grand Prairie, TX
- Nestlé Purina PetCare Co., St. Louis, MO

> *"No one knows the cost of a defective product—don't tell me you do. You know the cost of replacing it, but not the cost of a dissatisfied customer."*
>
> *—W. Edwards Deming*

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1. "Basic Concepts, Definitions," American Society of Quality, (accessed November 3, 2011). ↵
2. Galaxy Note7 Safety Recall and Exchange Program. (n.d.). Retrieved March 01, 2017, from http://www.samsung.com/us/note7recall/ ↵
3. El-Naggar, Mona (26 July 2013). "In Lieu of Money, Toyota Donates Efficiency to New York Charity". The New York Times. Retrieved 1 September 2013. ↵
4. "ISO Survey of Certifications," 2009 International Organization for Standardization, (accessed November 2, 2011). ↵
5. National Institute of Standards and Technology, "Frequently Asked Questions about the Malcolm Baldrige National Quality Award," November 25, 2008, (accessed August 14, 2009). ↵

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12.8: Putting It Together- Managing Processes

Synthesis

In this module you were given an overview of and insight into the world of operations management and the key role it plays in delivering high-quality goods and services to customers. We can sum up operations management by saying that it's the functional area within organizations that makes sure that the right customer gets the right product at the right time for the right price in a form that meets the customer's quality expectations. It's a pretty tall order, and it requires operations managers to be involved in every facet of the business process.

Regardless of how much market demand there is for a given product, good, or service, if the organization cannot consistently deliver it, then consumers will either find a substitute or simply do without. Consider the following examples, and you'll begin to register the impact of poor operations management:

Have you ever . . .

- Left a restaurant because the wait was too long or the service too slow?
- Returned an item to the store because it was defective or broke shortly after you bought it?
- Stayed in a hotel and vowed never to go there again because the hot water didn't work or the room wasn't clean?
- Attended a Thanksgiving dinner where the turkey was bone dry and the sweet potato pie was crunchy?

Doing something a little inefficiently one time is no big deal, but when you do something inefficiently over and over, hundreds or even millions of times per year, even little mistakes can add up to incredible waste. Mistakes in an operation that result in defective products, even if they represent only **1 percent** of total output, can alienate millions of customers. Similarly, if poorly designed operations result in habitually serving customers late, a company will eventually lose customers to better-functioning competitors.

As you can see, breakdowns in operations management can be very disappointing to the consumer and costly to the organization!

Summary

In this module you learned about how operations management contributes to organizational success in business. Below is a summary of the key points covered.

Operations Management

Operations management is responsible for all the activities involved in transforming a concept into a finished product or service. Included in these activities are planning and controlling the systems that produce these goods and services.

Production Processes

Operations management includes decisions about the way in which production will proceed. Common production processes include project-based, batch, mass, and continuous production.

The layout of a facility is most often determined by the product being manufactured. The four types of facility layouts are process, product, cellular, and fixed position.

Mining, Warehousing, and Sharing Data

Many aspects of business operations rely on data and information to inform their decisions. Today's companies have sophisticated tools for mining, warehousing, and sharing data on everything from customers to inventory and sales.

Production Planning

Depending on the product being manufactured, operations planning needs to decide where the facility will be located, how the facility will be organized, and the materials needed for production. Another major part of operations planning is scheduling the various activities that go into the production process. Three tools that are used by operations managers to ensure that projects and tasks are completed on time are the Gantt, PERT, and the critical path method.

New Technologies

Just as technology has revolutionized the average home, it has also transformed the way products are manufactured. Using technologies such as CAD (computer-aided design), CAM (computer-aided manufacturing), CIM (computer-integrated manufacturing), flexible manufacturing, and 3D printing, companies are able to manufacture products faster and more efficiently.

Supply Chain Management and Logistics

Supply chain management refers to the management activities that maximize customer value and allow the company to gain a competitive advantage. It represents a conscious effort among firms to work in the most efficient ways possible. Supply chain activities cover everything from product development, sourcing of materials, actual production, and transportation logistics.

Quality Assurance

The cost of poor quality can range from a small refund to a single, dissatisfied customer to global product recalls. In order to ensure that their products, goods, and services meet consumer quality standards, companies can employ quality-control techniques such as SPC, benchmarking, lean manufacturing, and Six Sigma. They can also seek certification through national and international quality-assurance organizations.

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CHAPTER OVERVIEW

13: Marketing Function

13.1: Why It Matters- Marketing Function
13.2: Role of Customers
13.3: Segmentation and Targeting
13.4: Marketing Mix Introduction
13.5: Putting It Together- Marketing Function

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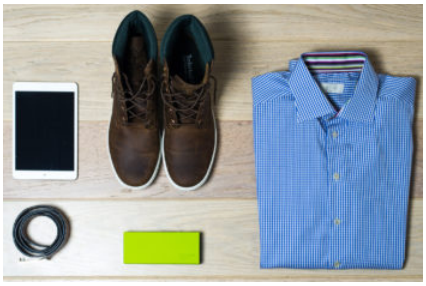
13.1: Why It Matters- Marketing Function

Why explain the key components of the marketing function?



How did your day start today? If you are like most people, you woke up to an alarm that rang on a Smartphone, and you climbed of bed and stumbled over to your favorite morning beverage, be it coffee, soda, or tea. You may have turned on your TV to check the weather while you got ready for your shower. You washed your hair, brushed your teeth, and got dressed. If you headed out to work or school, you probably got in your car or someone else's car for the drive. If you were rushed, maybe you went through the drive-thru of a fast-food restaurant and grabbed breakfast on your way to your final destination. In between these activities there were probably a hundred other small things that happened as part of your routine. Things like giving the dog a treat, applying makeup, making your lunch, packing up your book bag or briefcase. All of these activities have a one thing in common: they are all directly related to a company's marketing efforts.

How is that possible? What type of phone do you have: iPhone, Android, Windows? Which brand of coffee or sofa did you drink? What shampoo did you use? What make and model of car did you ride in or drive? Which fast-food restaurant did you visit? Where do you work or go to school? More important: *Why* do you use the things you use? Buy the things you buy? Eat where you eat? MARKETING.

Company's expend a vast quantity of their resources to get their products into your hands, homes, or stomachs. How? They identify the market for their products, goods, and services and then market to the consumers (you) who make up that market. By focusing on the consumer, meeting their demands, and keeping them happy, companies expand their market presence and, as a result, increase their sales and profits.

In this section you will explore the role that customers play in today's marketing efforts and learn how companies segment the market to better target prospective customers. You'll also get an introduction to the mix of marketing components a company can use to achieve its sales goals. In the words of Stanley Marcus, founder of the department store Neiman Marcus, businesses use marketing as a way to ensure that they "sell products that don't come back, to people who do."

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13.2: Role of Customers

Learning Objectives

- Explain the marketing concept
- Explain the importance of managing the customer relationship
- Explain the consumer buying process

Marketing Defined

What Is Marketing?

Marketing is a set of activities related to creating, communicating, delivering, and exchanging offerings that have value for others. In business, the function of marketing is to bring value to customers, whom the business seeks to identify, satisfy, and retain. This module will emphasize the role of marketing in business, but many of the concepts will apply to non-profit organizations, advocacy campaigns, and other activities aimed at influencing perceptions and behavior.

The Art of the Exchange

In marketing, the act of obtaining a desired object from someone by offering something of value in return is called the **exchange process**. The exchange involves:

- **the customer (or buyer):** a person or organization with a want or need who is willing to give money or some other personal resource to address this need
- **the product:** a physical good, a service, experience or idea designed to fill the customer's want or need
- **the provider (or seller):** the company or organization offering a need-satisfying thing, which may be a product, service, experience or idea
- **the transaction:** the terms around which both parties agree to trade value-for-value (most often, money for product)

Individuals on both sides of the exchange try to maximize rewards and minimize costs in transactions, in order to gain the most profitable outcomes. Ideally, everyone achieves a satisfactory level of reward.

Marketing creates a **bundle of goods and services** that the company offers at a price to its customers. The bundle consists of a tangible good, an intangible service or benefit, and the price of the offering. When you compare one car to another, for example, you can evaluate each of these dimensions—the tangible, the intangible, and the price—separately. However, you can't buy one manufacturer's car, another manufacturer's service, and a third manufacturer's price when you actually make a choice. Together, the three make up a single firm's offer or bundle.

Marketing is also responsible for the entire environment in which this exchange of value takes place.

- Marketing identifies customers, their needs, and how much value they place on getting those needs addressed.
- Marketing informs the design of the product to ensure it meets customer needs and provides value proportional to what it costs.
- Marketing is responsible for communicating with customers about products, explaining who is offering them and why they are desirable.
- Marketing is also responsible for listening to customers and communicating back to the provider about how well they are satisfying customer needs and opportunities for improvement.
- Marketing shapes the location and terms of the transaction, as well as the experience customers have after the product is delivered.

Marketing Creates Value for Customers

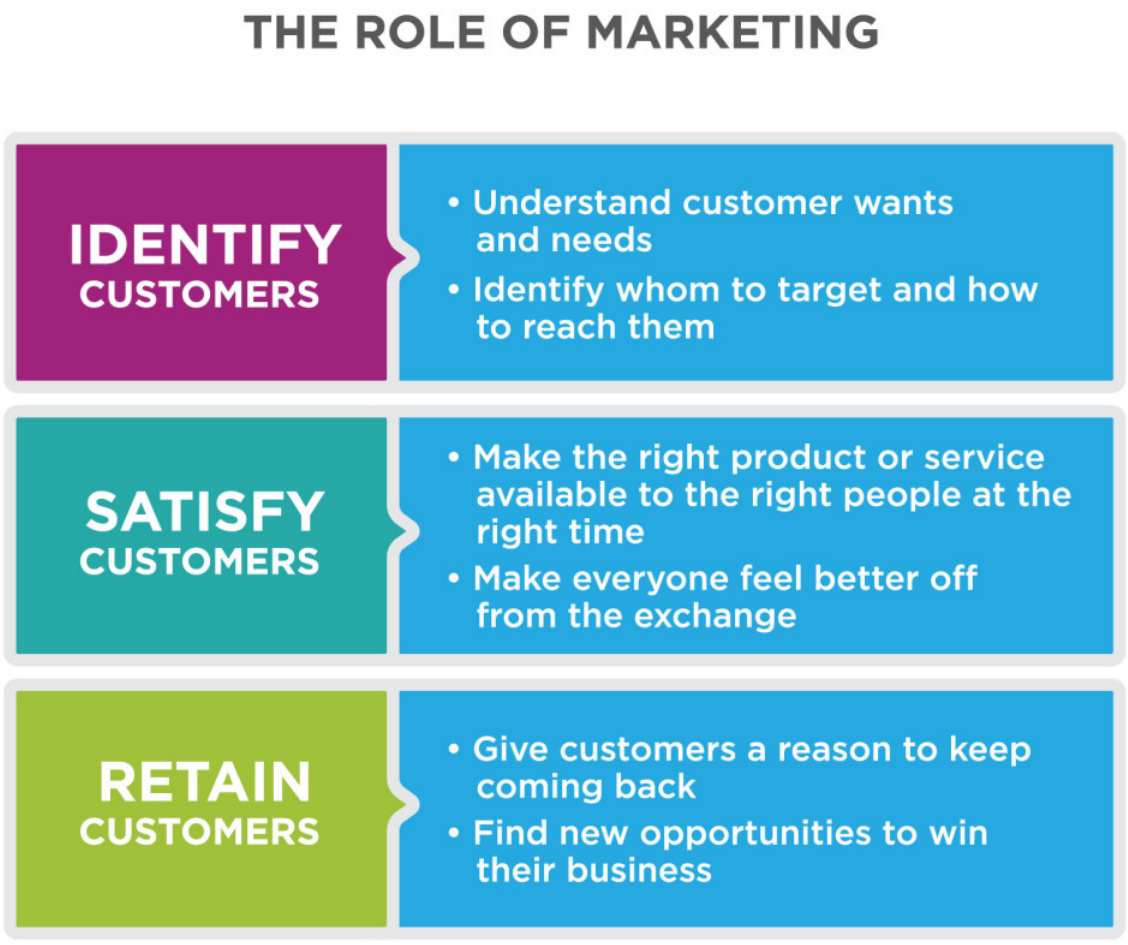
According to the influential economist and Harvard Business School professor Theodore Levitt, the purpose of all business is to "find and keep customers." Marketing is instrumental in helping businesses achieve this purpose and is much more than just advertising and selling products and collecting money. Marketing generates value by creating the connections between people and products, customers and companies.

How does this happen? Boiled down to its essence, the **role of marketing** is to *identify, satisfy,* and *retain customers*.

Before you can create anything of value, first you must **identify** a want or need that you can address, as well as the prospective customers who possess this want or need.

Next, you work to **satisfy** these customers by delivering a product or service that addresses these needs at the time customers want it. Key to customer satisfaction is making sure everyone feels they benefit from the exchange. Your customer is happy with the value they get for what they pay. You are happy with the payment you receive in exchange for what you provide.

Effective marketing doesn't stop there. It also needs to **retain** customers by creating new opportunities to win customer loyalty and business.



As you will learn in this module, marketing encompasses a variety of activities focused on accomplishing these objectives. How companies approach and conduct day-to-day marketing activities varies widely. For many large, highly visible companies, such as Disney-ABC, Proctor & Gamble, Sony, and Toyota, marketing represents a major expenditure. Such companies rely on effective marketing for business success, and this dependence is reflected in their organizational strategies, budget, and operations. Conversely, for other organizations, particularly those in highly regulated or less competitive industries such as utilities, social

services, medical care, or businesses providing one-of-a-kind products, marketing may be much less visible. It could even be as simple as a Web site or an informational brochure.

There is no one model that guarantees marketing success. Effective marketing may be very expensive, or it may cost next to nothing. What marketing must do in all cases is to help the organization identify, satisfy, and retain customers. Regardless of size or complexity, a marketing program is worth the costs only if it facilitates the organization's ability to reach its goals.

How Companies Approach Marketing

Company Orientation

When companies develop a marketing strategy, they make decisions about the direction that the company and their marketing efforts will take. Companies can focus on the customer, product, sales, or production. As the business environment has changed over time, so has the way that companies focus their marketing efforts.

The Marketing Concept

An organization adopts the marketing concept when it takes steps to know as much about the consumer as possible, coupled with a decision to base marketing, product, and even strategy decisions on this information. These organizations start with the customers' needs and work backward from there to create value, rather than starting with some other factor like production capacity or an innovative invention. They operate on the assumption that success depends on doing better than competitors at understanding, creating, delivering, and communicating value to their target customers.

The Product Concept

Both historically and currently, many businesses do not follow the marketing concept. For many years, companies such as Texas Instruments and Otis Elevator have followed a *product orientation*, in which the primary organizational focus is technology and innovation. All parts of these organizations invest heavily in building and showcasing impressive features and product advances, which are the areas in which these companies prefer to compete. This approach is also known as the *product concept*. Rather than focusing on a deep understanding of customer needs, these companies assume that a technically superior or less expensive product will sell itself. While this approach can be very profitable, there is a high risk of losing touch with what customers actually want. This leaves product-oriented companies vulnerable to more customer-oriented competitors.

The Sales Concept

Other companies follow a *sales orientation.* These businesses emphasize the sales process and try to make it as effective as possible. While companies in any industry may adopt the sales concept, multilevel-marketing companies such as Herbalife and Amway generally fall into this category. Many business-to-business companies with dedicated sales teams also fit this profile. These organizations assume that a good salesperson with the right tools and incentives is capable of selling almost anything. Sales and marketing techniques include aggressive sales methods, promotions, and other activities that support the sale. Often, this focus on the selling process may ignore the customer or view the customer as someone to be manipulated. These companies sell what they make, which isn't necessarily what customers want.

The Production Concept

Ford assembly line, 1913, Highland Park, Michigan

The *production concept* is followed by organizations that are striving for low-production costs, highly efficient processes, and mass distribution (which enables them to deliver low-cost goods at the best price). This approach came into popularity during the Industrial Revolution of the late 1800s, when businesses were beginning to exploit opportunities associated with automation and mass production. Production-oriented companies assume that customers care most about low-cost products being readily available and less about specific product features. Henry Ford's success with the groundbreaking assembly-line–built Model T is a classic example of the production concept in action. Today this approach is still widely successful in developing countries seeking economic gains in the manufacturing sector.

Seeing the Whole Picture

Savvy businesses acknowledge the importance of product features, production, and sales, but they also realize that in today's business environment a marketing orientation will lead to the greatest success when businesses continuously collect information

about customers' needs and competitors' capabilities; share the information across departments; and use the information to create a competitive advantage by increasing value for customers.

Value Proposition

What Is Value?

Marketing exists to help organizations understand, reach, and deliver value to their customers. In it's simplest form, **value** is the measure of the benefit gained from a product or service relative to the full cost of the item. In the process of the marketing exchange, value must be created.

$$\text{Value} = \text{benefit} - \text{cost}$$

Let's look at a simple example: If you and I decide to give each other a $5 bill at the same moment, is value created? I hand my $5 bill to you, and you hand yours to me. It is hard to say that either of us receives a benefit greater than the $5 bill we just received. There is no value in the exchange.

Now, imagine that you are passing by a machine that dispenses bus tickets. The machine is malfunctioning and will only accept $1 bills. The bus is about to arrive and a man in front of the machine asks if you would be willing to give him four $1 bills in exchange for a $5 bill. You could, of course, decide to make change for him (and give him five $1 bills), making this an "even exchange." But let's say you agree to his proposal of exchanging four $1 bills for a $5. In that moment a $1 bill is worth $1.25 to him. How does that make sense in the value equation? From his perspective, the ability to use the bus ticket dispenser *in that moment* adds value in the transaction.

Value is not simply a question of the financial costs and financial benefits. It includes perceptions of benefit that are different for every person. The marketer has to understand what is of greatest value to the target customer, and then use that information to develop a total offering that *creates value*.

Value Is More Than Price

You will notice that we did not express value as value = benefit – price. Price plays an important role in defining value, but it's not the only consideration. Let's look at a few typical examples:

- Two products have exactly the same ingredients, but a customer selects the higher-priced product because of the name brand

For the marketer, this means that the brand is *adding value* in the transaction.

- A customer shopping online selects a product but abandons the order before paying because there are too many steps in the purchase process

The inconvenience of filling in many forms, or concerns about providing personal information, can *add cost* (which will subtract from the value the customer perceives).

- An individual who is interested in a political cause commits to attending a meeting, but cancels when he realizes that he doesn't know anyone attending and that the meeting is on the other side of town.

For this person, the benefit of attending and participating is lower because of costs related to personal connection and convenience.

As you saw in these examples, the process of determining the value of an offering and then aligning it with the wants and needs of a target customer is challenging. As you continue through this section, think about what *you* value and how that impacts the buying decisions you make every day.

Value in a Competitive Marketplace

As if understanding individual perceptions of value weren't difficult enough, the presence of competitors further complicates perceptions of value. Customers instinctively make choices between competitive offerings based on *perceived value*.

Imagine that you are traveling to Seattle, Washington, with a group of six friends for a school event. You have the option to stay at a Marriott Courtyard Hotel that is located next to the event venue for $95 per night. If you pay the "additional person fee," you could share the room with one friend for a cost of $50 per night. However, one of your friends finds an AirBnB listing for an entire apartment that sleeps six people. Cost: $280 per night. That takes the price down to $40 per night, but the apartment is five miles away from the venue and, since there are seven of you, you would likely be sleeping on a couch or fighting for a bed. It has a more personal feel and a kitchen, but you will really be staying in someone else's place with your friends. It's an interesting dilemma. Regardless of which option you would really choose, consider the differences in the value of each and how the presence of both

options generates unavoidable comparisons: the introduction of the AirBnb alternative has the effect of highlighting new shortcomings and benefits of the Marriott Courtyard hotel room.

Competition, Substitutes and Differentiation

Alternatives generally fall into two categories: competitors and substitutes. A **competitor** is providing the same offering but is accentuating different features and benefits. If, say, you are evaluating a Marriott Courtyard hotel room vs. a Hilton Hampton Inn hotel room, then you are looking at *competitive offerings*. Both offerings are hotel rooms provided by different companies. The service includes different features, and the price and location vary, the sum of which creates different perceptions of value for customers.

AirBnb is a service that allows individuals to rent out their homes, apartments, or a single room. AirBnb does not offer hotel rooms; it offers an alternative to, or substitute for, a hotel room. ***Substitute offerings*** are viewed by the user as alternatives. The substitution is not a perfect replication of the offering, which means that it will provide different value to customers.

Competitors and substitutes force the marketer to identify the aspects of the offering that provide unique value vis-à-vis the alternatives. We refer to this as differentiation. **Differentiation** is simply the process of identifying and optimizing the elements of an offering that provide unique value to customers. Sometimes organizations refer to this process as competitive differentiation, since it is very focused on optimizing value in the context of the competitive landscape.

Finally, organizations seek to create an advantage in the marketplace whereby an organization's offerings provide greater value because of a unique strategy, asset, or approach that the firm uses that other cannot easily copy. This is a **competitive advantage**. The American Marketing Association defines competitive advantage as "as total offer, vis-à-vis relevant competition, that is more attractive to customers. It exists when the competencies of a firm permit the firm to outperform its competitors." When a company can create greater value for customers than its competitors, it has a competitive advantage.

What Is a Value Proposition?

We have discussed the complexity of understanding customer perceptions of value. As the company seeks to understand and optimize the value of its offering, it also must communicate the core elements of value to potential customers. Marketers do this through a **value proposition**, defined as follows:

> *"A business or marketing statement that summarizes why a consumer should buy a product or use a service. This statement should convince a potential consumer that one particular product or service will add more value or better solve a problem than other similar offerings.*[1]"

It is difficult to create an effective value proposition because it requires the marketer to distill many different elements of value and differentiation into one simple statement that can be easily read and understood. Despite the challenge, it is very important to create an effective value proposition. The value proposition focuses marketing efforts on the unique benefit to customers. This helps focus the offering on the customer and, more specifically, on the unique value to the customer. Also, the value proposition is a message, and the audience is the target customer. You want your value proposition to communicate, very succinctly, the promise of unique value in your offering.

A value proposition needs to very simply answer the question: Why should someone buy what you are offering? If you look closely at this question it contains three components:

- **Who?** The value proposition does not name the target buyer, but it must show clear value to the target buyer.
- **What?** The offering needs to be defined in the context of that buyer.
- **Why?** It must show that the offering is uniquely valuable to the buyer.

How Do You Create an Effective Value Proposition?

When creating or evaluating a value proposition, it is helpful to step away from the long lists of features and benefits and deep competitive analysis. Stick to the simple, and strive for focus and clarity. A value proposition should be clear, compelling, and differentiating.

- Clear: short and direct; immediately identifies both the offering and the value or benefit
- Compelling: conveys the benefit in a way that motivates the buyer to act
- Differentiating: sets the offering apart or differentiates it from other offerings

Marketing and Customer Relationships

Why Customers Matter

Marketing exists to help organizations understand, reach, and deliver value to their customers. For this reason, the customer is considered the cornerstone of marketing.

With this in mind, what is likely to happen when an organization doesn't understand or pay attention to what its customers want? What if an organization doesn't even really understand who its customers are?

One of the world's best-known brands, Coca-Cola, provides a high-profile example of misunderstanding customer "wants." In the following video, Roberto Goizueta—in his only on-camera interview on this topic—recounts the disastrous launch of New Coke in 1985 and describes the lessons the company learned. Goizueta was chairman, director, and chief executive officer of the Coca-Cola Company from August 1980 until his death in October 1997.

Customer Relationship Management: A Strategic Imperative

We have stated that the central purpose of marketing is to help organizations identify, satisfy, and retain their customers. These three activities lay the groundwork for what has become a strategic imperative in modern marketing: customer relationship management.

To a student of marketing in the digital age, the idea of relationship building between customers and companies may seem obvious and commonplace. It certainly is a natural outgrowth of the marketing concept, which orients entire organizations around understanding and addressing customer needs. But only in recent decades has technology made it possible for companies to capture and utilize information about their customers to such a great extent and in such meaningful ways. The Internet and digital social media have created new platforms for customers and product providers to find and communicate with one another. As a result, there are more tools now than ever before to help companies create, maintain, and manage customer relationships.

Maximizing Customer Lifetime Value

Central to these developments is the concept of customer lifetime value. Customer lifetime value predicts how much profit is associated with a customer during the course of their lifetime relationship with a company.[2] One-time customers usually have a relatively low customer lifetime value, while frequent, loyal, repeat-customers typically have a high customer lifetime value.

How do companies develop strong, ongoing relationships with customers who are likely to have a high customer lifetime value? Through marketing, of course.

Marketing applies a customer-oriented mindset and, through particular marketing activities, tries to make initial contact with customers and move them through various stages of the relationship—all with the goal of increasing lifetime customer value. These activities are summarized in the table below.

Relationship Stage	Typical Marketing Activities
Meeting and Getting Acquainted	• Find desirable target customers, including those likely to deliver a high customer lifetime value • Understand what these customers want • Build awareness and demand for what you offer • Capture new business
Providing a Satisfying Experience	• Measure and improve customer satisfaction • Track how customers' needs and wants evolve • Develop customer confidence, trust, and goodwill • Demonstrate and communicate competitive advantage • Monitor and counter competitive forces
Sustain a Committed Relationship	• Convert contacts into loyal repeat customers, rather than one-time customers • Anticipate and respond to evolving needs • Deepen relationships, expand reach of and reliance on what you offer

Another benefit of effective customer relationship management is that it reduces the cost of business and increases profitability. As a rule, winning a new customer's business takes significantly more time, effort, and marketing resources than it does to renew or expand business with an existing customer.

Customer Relationship As Competitive Advantage

As the global marketplace provides more and more choices for consumers, relationships can become a primary driver of why a customer chooses one company over others (or chooses none at all). When customers feel satisfaction with and affinity for a specific company or product, it simplifies their buying choices.

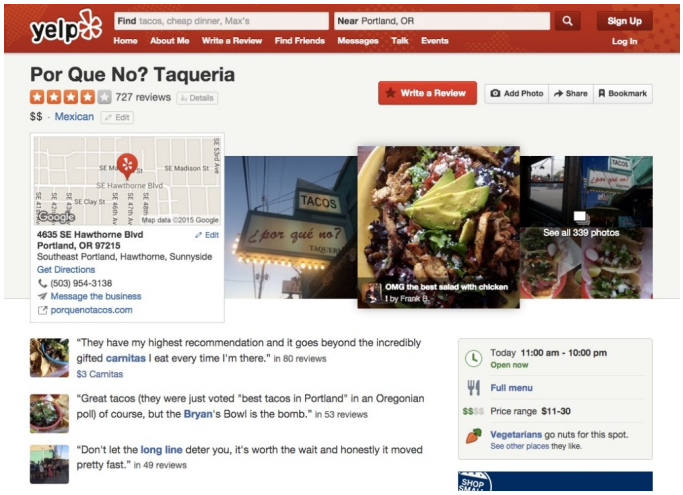
For example, why might a woman shopping for a cocktail dress choose to go to Nordstrom rather than Macy's or Dillard's, or pick from an army of online stores? Possibly because she prefers the selection of dresses at Nordstrom and the store's atmosphere. It's much more likely, though, that thanks to Nordstrom's practices, this shopper has a relationship with an attentive sales associate who has helped her find great outfits and accessories in the past. She also knows about the store's customer-friendly return policy, which might come in handy if she needs to return something.

A company like Nordstrom delivers such satisfactory experiences that its customers return again and again. A consistently positive customer experience matures into a relationship in which the customer becomes increasingly receptive to the company and its products. Over time, the customer relationship gives Nordstrom a competitive advantage over other traditional department stores and online retailers.

When Customers Become Your Best Marketing Tool

Customer testimonials and recommendations have always been powerful marketing tools. They often work to persuade new customers to give something a try. In today's digital media landscape there is unprecedented opportunity for companies to engage customers as credible advocates. When organizations invest in building strong customer relationships, these activities become particularly fruitful.

For example, service providers like restaurateurs, physical therapists, and dentists frequently ask regular patrons and patients to write reviews about their real-life experiences on popular recommendation sites like Yelp and Google+. Product providers do the same on sites like Amazon and CNET.com. Although companies risk getting a bad review, they usually gain more by harnessing the credible voices and authentic experiences of customers they have served. In this process they also gain invaluable feedback about what's working or not working for their customers. Using this input, they can retool their products or approach to better match what customers want and improve business over time.



Additionally, smart marketers know that when people take a public stance on a product or issue, they tend to become more committed to that position. Thus, customer relationship management can become a virtuous cycle. As customers have more exposure and positive interaction with a company and its products, they want to become more deeply engaged, and they are more likely to become vocal evangelists who share their opinions publicly. Customers become an active part of a marketing engine that generates new business and retains loyal customers for repeat business and increased customer lifetime value.

Influences on Consumer Decisions

What, Exactly, Influences a Purchasing Decision?

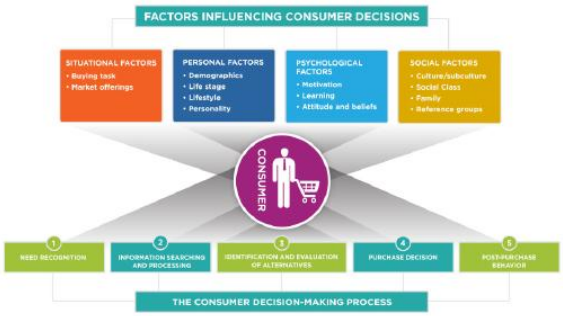
While the decision-making process itself appears quite standardized, no two people make a decision in exactly the same way. People have many beliefs and behavioral tendencies—some controllable, some beyond our control. How all these factors interact with each other ensures that each of us is unique in our consumer actions and choices.

Although it isn't feasible for marketers to react to the complex, individual profiles of every single consumer, it is possible to identify factors that tend to influence most consumers in predictable ways.

The factors that influence the consumer problem-solving process are many and complex. For example, as groups, men and women express very different needs and behaviors regarding personal-care products. Families with young children tend to make different dining-out choices than single and married people with no children. A consumer with a lot of prior purchasing experience in a product category might approach the decision differently from someone with no experience. As marketers gain a better understanding of these influencing factors, they can draw more accurate conclusions about consumer behavior.

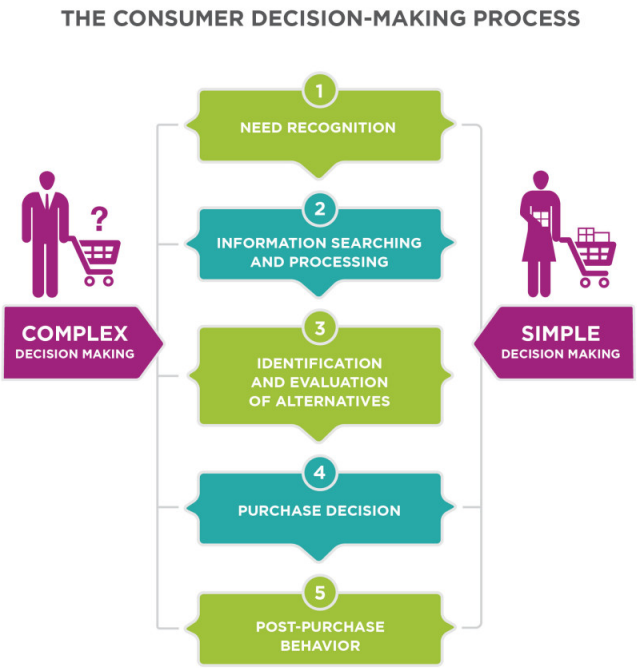
We can group these influencing factors into four sets, illustrated in the figure below:

- **Situational Factors** pertain to the consumer's level of involvement in a buying task and the market offerings that are available
- **Personal Factors** are individual characteristics and traits such as age, life stage, economic situation, and personality
- **Psychological Factors** relate to the consumer's motivation, learning, socialization, attitudes, and beliefs
- **Social Factors** pertain to the influence of culture, social class, family, and reference groups



Buying-Process Stages

Figure 13.2.1, below, outlines the process a consumer goes through in making a purchase decision. Once the process is started, a potential buyer can withdraw at any stage before making the actual purchase. This six-stage process represents the steps people undergo when they make a conscious effort to learn about the options and select a product–the first time they purchase a product, for instance, or when buying high-priced, long-lasting items they don't purchase frequently. This is called *complex decision making*.



For many products, the purchasing behavior is routine: you notice a need and you satisfy that need according to your habit of repurchasing the same brand or the cheapest brand or the most convenient alternative, depending on your personal assessment of trade-offs and value. In these situations, you have learned from your past experiences what will best satisfy your need, so you can bypass the second and third stages of the process. This is called *simple decision making*. However, if something changes appreciably (price, product, availability, services), then you may re-enter the full decision process and consider alternative brands.

The following section discusses each step of the consumer decision-making process.

Need Recognition

The first step of the consumer decision process is recognizing that there is a problem–or unmet need–and that this need warrants some action. Whether we act to resolve a particular problem depends upon two factors: (1) the magnitude of the difference between what we have and what we need, and (2) the importance of the problem. A man may desire a new Lexus and own a five-year-old Ford Focus. The discrepancy may be fairly large but relatively unimportant compared to the other problems he faces. Conversely, a woman may own a two-year-old car that is running well, but for various reasons she considers it extremely important to purchase another car this year. Consumers do not move on to the next step until they have confirmed that their specific needs are important enough to act on.

Information Search

After recognizing a need, the prospective consumer may seek information to help identify and evaluate alternative products, services, experiences, and outlets that will meet that need. Information may come from any number of sources: family and friends, search engines, Yelp reviews, personal observation, *Consumer Reports*, salespeople, product samples, and so forth. Which sources are most important depends on the individual and the type of purchase he or she is considering.

The information-search process can also identify new needs. As a tire shopper looks for information, she may decide that the tires are not the real problem, but instead she needs a new car. At this point, her newly perceived need may trigger a new information search.

Evaluation of Alternatives

As a consumer finds and processes information about the problem she is trying to solve, she identifies the alternative products, services, and outlets that are viable options. The next step is to evaluate these alternatives and make a choice, assuming a choice is possible that meets the consumer's financial and psychological requirements. Evaluation criteria vary from consumer to consumer and from purchase to purchase, just as the needs and information sources vary. One consumer may consider price most important while another puts more weight on quality or convenience.

Consider a situation in which you are buying a new vacuum cleaner. During your information search process, you identified five leading models in online reviews, as well as a set of evaluation criteria that are most important to you: 1) price, 2) suction power, 3) warranty, 4) weight, 5) noise level, and 6) ease of using attachments. After visiting Sears and Home Depot to check out all the options in person, you're torn between two models you short-listed. Finally you make the agonizing choice, and the salesperson heads to the warehouse to get one for you. He returns with bad news: The vacuum cleaner is out of stock, but a new shipment is expected in three days. Strangely relieved, you take that as a sign to go for the other model, which happens to be in stock. Although convenience wasn't on your original list of selection criteria, you need the vacuum cleaner before the party you're having the next day. You pick the number-two choice and never look back.

The Purchase Decision

After much searching and evaluating (or perhaps very little), consumers at some point have to decide whether they are going to buy. Anything marketers can do to simplify purchasing will be attractive to buyers. For example, in advertising, marketers might suggest the best size of product for a particular use or the right wine to drink with a particular food. Sometimes several decision situations can be combined and marketed as one package. For example, travel agents often package travel tours, and stores that sell appliances try to sell them with add-on warranties.

Postpurchase Behavior

All the behavior determinants and the steps of the buying process up to this point take place before or during the time a purchase is made. However, a consumer's feelings and evaluations after the sale are also significant to a marketer, because they can influence repeat sales and what the customer tells others about the product or brand.

Marketing is all about keeping the customer happy at every stage of the decision-making process, including postpurchase. It is normal for consumers to experience some postpurchase anxiety after any significant or nonroutine purchase. This anxiety reflects a phenomenon called *cognitive dissonance*. According to this theory, people strive for consistency among their cognitions (knowledge, attitudes, beliefs, and values). When there are inconsistencies, dissonance arises, which people try to eliminate.

Marketers may take specific steps to reduce postpurchase dissonance. One obvious way is to help ensure delivery of a quality solution that will satisfy customers. Another step is to develop advertising and new-customer communications that stress the many positive attributes or confirm the popularity of the product. Providing personal reinforcement has proven effective with big-ticket items such as automobiles and major appliances. Salespeople in these areas may send cards or even make personal calls in order to reassure customers about their purchase.

1. http://www.investopedia.com/terms/v/valueproposition.asp ↵
2. http://dictionary.cambridge.org/us/dictionary/english/customer-lifetime-value ↵

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13.3: Segmentation and Targeting

What you'll learn to do: explain the role of segmentation and targeting in marketing

Segmentation and targeting answer a basic question: Who am I trying to reach? In this section, first we will focus on why segmentation and targeting are so important. Then we will discuss how to conduct segmentation and targeting and use these tools to guide marketing activity.

Learning Objectives

- Explain how segmentation and targeting relate to marketing strategy
- Explain how market research helps marketers validate their target markets

Defining Your Target Market

Whom Are You Trying to Reach?

Suppose you are selling automotive detailing products. Is your target "anyone with money to pay for your product?" Or are you focusing your efforts on a tightly defined market segment of people with an identified need for what you are selling? "Anyone with money" is such a broad audience that it's difficult to make any impact at all with your marketing efforts or convince very many people that they need your product. If you narrow and carefully define your target market, though, your efforts will be more fruitful because they're focused on people with a preexisting need or interest in what you offer.

Step 1: Identify the Customer Need You Address

To define your total market, start by stating the needs you will fulfill: Who are your products or services intended for? Who do you want to do business with? What is unique about your product? If you're selling products used in automotive detailing, your total market consists of vehicle owners—that is, all the people who could potentially buy your product. Your business will help them keep their vehicles clean and shiny.

Step 2: Segment Your Total Market

Next, break down this large market into smaller sections, using a process known as segmentation. You can use a variety of approaches to segment your total market into groups with common wants or needs. In this case, we can segment by vehicle ownership and related behavior. Specific segments might include the following:

- People who restore classic automobiles
- People who drive old clunkers and run them through the car wash occasionally
- People who own "status" cars
- Truck drivers
- Motorcycle owners

Which of these subgroups are likely to be your most productive market segment(s)? You recognize that auto owners who don't care about keeping their cars clean and shiny probably won't be very interested in your products. Then there are those who care, but they lack the time and interest to do the work themselves. They take their vehicle to a shop. Others only worry about auto detailing only when it's time for a trade-in.

You reject these segments as unsuitable for your niche market because they probably don't care enough about what you offer. After further consideration and research, you decide that your market segment will be automobile owners who have both the time and the interest to do their own detailing work—people who enjoy puttering with their vehicles, who have the time to spend, and who take pride in their vehicle's appearance.

You need to conduct research to confirm that there are enough potential customers in that group to support your business. You should also do competitive analysis to confirm that what you are offering is not readily available to them elsewhere. With this validation, you move to step three.

Step 3: Profile Your Target Customer Segment(s)

Next, develop profiles of your target customer(s) to get a true picture of the people you're trying to serve. Describe these potential customers as fully as you can. Who will actually buy your product? What do you know about them? Where do they live and what languages do they speak? How much do they spend on car detailing? Where do they shop? What is their annual income? What kinds of cars do they drive? If you're selling online, what methods do they prefer for online payment? What type of Web sites do they visit? How do they want their product delivered?

There are many different ways to profile your customers, as shown in the table and graphic, below.

Table 13.3.1. Common Market Segmentation Approaches

Type of Approach	Segmentation Criteria
Geographic	nations, states, regions, cities, neighborhoods, zip codes, etc.
Demographic	age, gender, family size, income, occupation, education, religion, ethnicity, and nationality
Psychographic	lifestyle, personality, attitudes, and social class
Behavioral	user status, purchase occasion, loyalty, readiness to buy
Decision maker	decision-making role (purchaser, influencer, etc.)

Identify your customer profile before you conduct market planning, so that your planning is a good fit for your customers' behavior, interests, and needs.

Step 4: Research and Validate Your Market Opportunity

Now that you have fully identified your target market, conduct research to verify that there will be enough business in this group to support your company in its growth. This process confirms that the need actually exists and that it's not just wishful thinking on your part.

Use both primary and secondary sources in your research. You might consult business directories, obtain statistics regarding automobile owners and their car-care practices, or locate newspaper articles and magazine stories written on the subject. You can also conduct your own market research using techniques such as surveys, focus groups, interviews, and so forth.

Your research should also determine the size of the market opportunity in terms of revenue as well as your potential market share.

You can use primary and secondary sources to find out how many potential customers there are in the geographic area you have defined and how many businesses are directly or indirectly competing with you. Your market share will be the number of customers likely to buy from you rather than from your competition.

Having defined and validated your target market, you are now better positioned to develop a marketing plan that will reach your potential customers. Perhaps your sales will take off right away—a great problem to have!

The Importance of Marketing Information and Research

Fresh Customer Insights

Effective marketing starts with a strong knowledge of your customers: the kind of knowledge that gives you unique insights into what they want and how to satisfy them better than the competition. The most reliable source of fresh customer insights is good **marketing information**. Useful marketing information may come from a variety of sources both inside and outside your organization. Marketing information is generated by a variety of different activities, including marketing research.

Marketing research is a systematic process for identifying marketing opportunities and solving marketing problems, using customer insights that come out of collecting and analyzing marketing information. The mechanics of marketing research must be controlled so that marketers uncover the relevant facts to answer the problem at hand. Control over this fact-finding process is the responsibility of the marketing research director, who must correctly design the research and carefully supervise its execution, to ensure it yields the customer insights the organization needs.

A marketing information system is a combination of people, technologies, and processes for managing marketing information, overseeing market research activities, and using customer insights to guide marketing decisions and broader management and strategy decisions.

Knowledge Is Power Against the Competition

The business environment is increasingly competitive. With something as simple as a Google search, customers have unprecedented opportunities to explore alternatives to what any single company offers. Likewise, companies have ample opportunity to identify, track, and lure customers away from their less-vigilant competitors. A regular infusion of fresh customer insights can make all the difference between keeping customers and losing them. Marketing information and research are essential tools for marketers and the management team as they align strategy with customer wants and needs.

Consider the following examples:

- Before introducing OnStar, the first-ever embedded wireless service in cars, GM used marketing research to understand what types of applications would make consumers most interested in subscribing to the service and how much they would pay for it. Of all the benefits OnStar could offer, the research helped GM prioritize how the initial service would provide value, focusing on driver assistance and security. Research also helped determine OnStar pricing to help the company build a large subscriber base quickly.[1]
- Enterprise systems provider PeopleSoft recruited a diverse set of universities as early-adopter "Beta" partners to provide input as it designed a new student information system for higher education. This marketing research helped PeopleSoft create a versatile system that could support the needs of a variety of colleges and universities, ultimately leading to strong receptivity and market share when the new system became widely available.[2]
- Marketing research to track brand awareness and perceptions helped the World Wildlife Fund (WWF) understand that it had an image problem. Although millions of people recognized and liked the brand, relatively few of them understood what the nonprofit organization actually does for habitat conservation worldwide. Instead, most thought of it as simply the "endangered species" people. With additional research, the organization found that when it communicated effectively about the full scope of its mission, people felt even stronger positive associations, making them more likely to support or affiliate with the nonprofit.[3]

What Should Marketers Investigate Using Marketing Information?

An easy—and truthful—answer to this question is "everything." There is no aspect of marketing to which information and research do not apply. Every marketing concept and every element involved in the marketing management process can be subjected to a great deal of careful marketing research and inquiry. Some important questions include:

- Who is the customer?
- What problems is the customer trying to solve with a given purchase?
- What does s/he desire in the way of satisfaction?
- How does the customer get information about available choices?
- Where does s/he choose to purchase?
- Why does s/he buy, or not buy?
- When does s/he purchase?
- How does s/he go about seeking satisfaction in the market?

Seeking answers to these questions yields insights into the customer's needs, perceptions, and behaviors. Another area in which research is critical is profitability. Organizations need to forecast sales and related costs in order to understand how their operations will be profitable. They also need to plan competitive marketing programs that will produce the desired level of sales at an appropriate cost. The analysis of past sales and interpretation of cost information are important in evaluating performance and providing useful facts for future planning. All these activities rely on marketing information and a rigorous marketing research process to produce insights managers can trust and act on.

When to Use Marketing Information and Research

Many marketing decisions are made without consulting marketing information or the use of formal marketing research. For example, a decision maker may feel she already knows enough to make a good decision. The time required to investigate a question or conduct formal marketing research may not be available. In other cases, the cost of obtaining the data is prohibitive, or the desired data cannot be obtained in reliable form. In a few instances, there may be no choice among alternatives and therefore no decision to make because there is little value in spending time and money to study a problem if there is only one possible solution. But in most business situations, marketers and managers must choose among two or more courses of action. This is where fact-finding, marketing information, and research enter to help make the choice.

Marketing information and research address the need for quicker, yet more accurate, decision making by the marketer. These tools put marketers close to their customers to help them understand who they customers are, what they want, and what competitors are doing. When different stakeholders have very different views about a particular marketing-related decision, objective information and research can inform everyone about the issues in question and help the organization come to agreement about the path forward. Good research should help align marketing with the other areas of the business.

Marketers should always be tapping into regular sources of marketing information about their organization and industry in order to monitor what's happening generally. For example, at any given time marketers should understand how they are doing relative to sales goals and monitor developments in their industry or competitive set.

Beyond this general level of "tuning in," additional market research projects may also be justified. As a rule, if the research results can save the company more time, money, and/or risk than it costs to conduct the research, it is wise to proceed. If the cost of conducting the research is more than it will contribute to improving a decision, the research should not be carried out. In practice, applying this cost-test principle can be somewhat complex, but it provides useful guidance about when marketing research is worthwhile. Ultimately, successful marketing executives make decisions on the basis of a blend of facts and intuition.

Fact: top performers research customer preferences

In 2010, the management consultancy McKinsey published research about the difference between organizations that produced top-performing products and those that produced under-performing products. The use of marketing research was a striking differentiator:

> *"More than 80 percent of the top performers said they periodically tested and validated customer preferences during the development process, compared with just 43 percent of bottom performers. They were also twice as likely as the laggards to research what, exactly, customers wanted.*[4]"

The study also identified other differences between top and bottom performers, but an underlying theme was the emphasis successful projects and companies placed on understanding their customers and adjusting course when necessary to better address customers' needs. This research provides more than anecdotal evidence that marketing research and well-applied marketing information can make a substantial contribution to an organization's success.

The Marketing Research Process

Marketing research is a useful and necessary tool for helping marketers and an organization's executive leadership make wise decisions. Carrying out marketing research can involve highly specialized skills that go deeper than the information outlined in this module. However, it's important for any marketer to be familiar with the basic procedures and techniques of marketing research.

It's very likely that at some point a marketing professional will need to supervise an internal marketing research activity or to work with an outside marketing research firm to conduct a research project. Managers who understand the research function can do a better job of framing the problem and critically appraising the proposals made by research specialists. They are also in a better position to evaluate their findings and recommendations.

Periodically marketers themselves need to find solutions to marketing problems without the assistance of marketing research specialists inside or outside the company. If you are familiar with the basic procedures of marketing research, you can supervise and even conduct a reasonably satisfactory search for the information needed.

Step 1: Identify the Problem

The first step for any marketing research activity is to clearly identify and define the problem you are trying to solve. You start by stating the marketing or business problem you need to address and for which you need additional information to figure out a solution. Next, articulate the objectives for the research: What do you want to understand by the time the research project is completed? What specific information, guidance, or recommendations need to come out of the research in order to make it a worthwhile investment of the organization's time and money?

It's important to share the problem definition and research objectives with other team members to get their input and further refine your understanding of the problem and what is needed to solve it. At times, the problem you really need to solve is not the same problem that appears on the surface. Collaborating with other stakeholders helps refine your understanding of the problem, focus your thinking, and prioritize what you hope to learn from the research. Prioritizing your objectives is particularly helpful if you don't have the time or resources to investigate everything you want.

To flesh out your understanding of the problem, it's useful to begin brainstorming actual research questions you want to explore. What are the questions you need to answer in order to get to the research outcomes? What is the missing information that marketing research will help you find? The goal at this stage is to generate a set of preliminary, big-picture questions that will frame your research inquiry. You will revisit these research questions later in the process, but when you're getting started, this exercise helps clarify the scope of the project, whom you need to talk to, what information may already be available, and where to look for the information you don't yet have.

Marketing research for bookends

Your uncle Dan owns an independent bookstore called Bookends, and it's not doing very well. (That's you in the picture.) The store's sales are down, and the rent is going up. Dan has turned to you for help, since you know a thing or two about marketing.

You need a lot of information if you're going to help your uncle turn things around, so marketing research is a good idea. You begin by identifying the problem and then work to set down your research objectives and initial research questions:

Identifying Problems, Objectives, and Questions	
Core business problem Dan needs to solve	How to get more people to spend more money at Bookends
Research objectives	1. Identify promising target audiences for Bookends 2. Identify strategies for rapidly increasing revenue from these target audiences
Initial research questions	Who are Bookends' current customers? How much do they spend? Why do they come to Bookends? What do they wish Bookends offered? Who isn't coming to Bookends, and why?

Step 2: Develop a Research Plan

Once you have a problem definition, research objectives, and a preliminary set of research questions, the next step is to develop a research plan. Essential to this plan is identifying precisely what information you need to answer your questions and achieve your objectives. Do you need to understand customer opinions about something? Are you looking for a clearer picture of customer needs and related behaviors? Do you need sales, spending, or revenue data? Do you need information about competitors' products, or insight about what will make prospective customers notice you? When do need the information, and what's the time frame for getting it? What budget and resources are available?

Once you have clarified what kind of information you need and the timing and budget for your project, you can develop the research design. This details how you plan to collect and analyze the information you're after. Some types of information are readily available through *secondary research* and *secondary data* sources. Secondary research analyzes information that has already been collected for another purpose by a third party, such as a government agency, an industry association, or another company. Other types of information need to from talking directly to customers about your research questions. This is known as *primary research*, which collects *primary data* captured expressly for your research inquiry. Marketing research projects may include secondary research, primary research, or both.

Depending on your objectives and budget, sometimes a small-scale project will be enough to get the insight and direction you need. At other times, in order to reach the level of certainty or detail required, you may need larger-scale research involving participation from hundreds or even thousands of individual consumers. The research plan lays out the information your project will capture—both primary and secondary data—and describes what you will do with it to get the answers you need. (Note: You'll learn more about data collection methods and when to use them later in this module.)

Your data collection plan goes hand in hand with your analysis plan. Different types of analysis yield different types of results. The analysis plan should match the type of data you are collecting, as well as the outcomes your project is seeking and the resources at your disposal. Simpler research designs tend to require simpler analysis techniques. More complex research designs can yield powerful results, such as understanding causality and trade-offs in customer perceptions. However, these more sophisticated designs can require more time and money to execute effectively, both in terms of data collection and analytical expertise.

The research plan also specifies who will conduct the research activities, including data collection, analysis, interpretation, and reporting on results. At times a singlehanded marketing manager or research specialist runs the entire research project. At other times, a company may contract with a marketing research analyst or consulting firm to conduct the research. In this situation, the marketing manager provides supervisory oversight to ensure the research delivers on expectations.

Finally, the research plan indicates who will interpret the research findings and how the findings will be reported. This part of the research plan should consider the internal audience(s) for the research and what reporting format will be most helpful. Often, senior executives are primary stakeholders, and they're anxious for marketing research to inform and validate their choices. When this is the case, getting their buy-in on the research plan is recommended to make sure that they are comfortable with the approach and receptive to the potential findings.

A Bookends Research plan

You talk over the results of your problem identification work with Dan. He thinks you're on the right track and wants to know what's next. You explain that the next step is to put together a detailed plan for getting answers to the research questions.

Dan is enthusiastic, but he's also short on money. You realize that such a financial constraint will limit what's possible, but with Dan's help you can do something worthwhile. Below is the research plan you sketch out:

Identifying Data Types, Timing and Budget, Data Collection Methods, Analysis, and Interpretation	
Types of data needed	1) Demographics and attitudes of current Bookends customers; 2) current customers' spending patterns; 3) metro area demographics (to determine types of people who aren't coming to the store)
Timing & budget	Complete project within 1 month; no out-of-pocket spending
Data collection methods	1) Current customer survey using free online survey tool, 2) store sales data mapped to customer survey results, 3) free U.S. census data on metro-area demographics, 4) 8–10 intercept ("man on the street") interviews with non-customers
Analysis plan	Use Excel or Google Sheets to tabulate data; Marina (statistician cousin) to assist in identifying data patterns that could become market segments
Interpretation and reporting	You and Dan will work together to comb through the data and see what insights it produces. You'll use PowerPoint to create a report that lays out significant results, key findings, and recommendations.

Step 3: Conduct the Research

Conducting research can be a fun and exciting part of the marketing research process. After struggling with the gaps in your knowledge of market dynamics—which led you to embark on a marketing research project in the first place—now things are about to change. Conducting research begins to generate information that helps answer your urgent marketing questions.

Typically data collection begins by reviewing any existing research and data that provide some information or insight about the problem. As a rule, this is secondary research. Prior research projects, internal data analyses, industry reports, customer-satisfaction survey results, and other information sources may be worthwhile to review. Even though these resources may not answer your research questions fully, they may further illuminate the problem you are trying to solve. Secondary research and data sources are nearly always cheaper than capturing new information on your own. Your marketing research project should benefit from prior work wherever possible.

After getting everything you can from secondary research, it's time to shift attention to primary research, if this is part of your research plan. Primary research involves asking questions and then listening to and/or observing the behavior of the target audience you are studying. In order to generate reliable, accurate results, it is important to use proper scientific methods for primary research data collection and analysis. This includes identifying the right individuals and number of people to talk to, using carefully worded surveys or interview scripts, and capturing data accurately.

Without proper techniques, you may inadvertently get bad data or discover bias in the responses that distorts the results and points you in the wrong direction. The module on Marketing Research Techniques discusses these issues in further detail, since the procedures for getting reliable data vary by research method.

Getting the data on bookends

Dan is on board with the research plan, and he's excited to dig into the project. You start with secondary data, getting a dump of Dan's sales data from the past two years, along with related information: customer name, zip code, frequency of purchase, gender, date of purchase, and discounts/promotions (if any).

You visit the U.S. Census Bureau Web site to download demographic data about your metro area. The data show all zip codes in the area, along with population size, gender breakdown, age ranges, income, and education levels.

The next part of the project is customer-survey data. You work with Dan to put together a short survey about customer attitudes toward Bookends, how often and why they come, where else they spend money on books and entertainment, and why they go

other places besides Bookends. Dan comes up with the great idea of offering a 5 percent discount coupon to anyone who completes the survey. Although it eats into his profits, this scheme gets more people to complete the survey and buy books, so it's worth it.

For a couple of days, you and Dan take turns doing "man on the street" interviews (you interview the guy in the red hat, for instance). You find people who say they've never been to Bookends and ask them a few questions about why they haven't visited the store, where else they buy books and other entertainment, and what might get them interested in visiting Bookends sometime. This is all a lot of work, but for a zero-budget project, it's coming together pretty well.

Step 4: Analyze and Report Findings

Analyzing the data obtained in a market survey involves transforming the primary and/or secondary data into useful information and insights that answer the research questions. This information is condensed into a format to be used by managers—usually a presentation or detailed report.

Analysis starts with formatting, cleaning, and editing the data to make sure that it's suitable for whatever analytical techniques are being used. Next, data are tabulated to show what's happening: What do customers actually think? What's happening with purchasing or other behaviors? How do revenue figures actually add up? Whatever the research questions, the analysis takes source data and applies analytical techniques to provide a clearer picture of what's going on. This process may involve simple or sophisticated techniques, depending on the research outcomes required. Common analytical techniques include regression analysis to determine correlations between factors; conjoint analysis to determine trade-offs and priorities; predictive modeling to anticipate patterns and causality; and analysis of unstructured data such as Internet search terms or social media posts to provide context and meaning around what people say and do.

Good analysis is important because the interpretation of research data—the "so what?" factor—depends on it. The analysis combs through data to paint a picture of what's going on. The interpretation goes further to explain what the research data mean and make recommendations about what managers need to know and do based on the research results. For example, what is the short list of key findings and takeaways that managers should remember from the research? What are the market segments you've identified, and which ones should you target? What are the primary reasons your customers choose your competitor's product over yours, and what does this mean for future improvements to your product?

Individuals with a good working knowledge of the business should be involved in interpreting the data because they are in the best position to identify significant insights and make recommendations from the research findings. Marketing research reports incorporate both analysis and interpretation of data to address the project objectives.

The final report for a marketing research project may be in written form or slide-presentation format, depending on organizational culture and management preferences. Often a slide presentation is the preferred format for initially sharing research results with internal stakeholders. Particularly for large, complex projects, a written report may be a better format for discussing detailed findings and nuances in the data, which managers can study and reference in the future.

analysis and Insights for bookends

Getting the data was a bit of a hassle, but now you've got it, and you're excited to see what it reveals. Your statistician cousin, Marina, turns out to be a whiz with both the sales data and the census data. She identified several demographic profiles in the metro area that looked a lot like lifestyle segments. Then she mapped Bookends' sales data into those segments to show who is and isn't visiting Bookends. After matching customer-survey data to the sales data, she broke down the segments further based on their spending levels and reasons they visit Bookends.

Gradually a clearer picture of Bookends' customers is beginning to emerge: who they are, why they come, why they don't come, and what role Bookends plays in their lives. Right away, a couple of higher-priority segments—based on their spending levels, proximity, and loyalty to Bookends—stand out. You and your uncle are definitely seeing some possibilities for making the bookstore a more prominent part of their lives. You capture these insights as "recommendations to be considered" while you evaluate the right marketing mix for each of the new segments you'd like to focus on.

Step 5: Take Action

Once the report is complete, the presentation is delivered, and the recommendations are made, the marketing research project is over, right? Wrong.

What comes next is arguably the most important step of all: taking action based on your research results.

If your project has done a good job interpreting the findings and translating them into recommendations for the marketing team and other areas of the business, this step may seem relatively straightforward. When the research results validate a path the organization is already on, the “take action” step can galvanize the team to move further and faster in that same direction.

Things are not so simple when the research results indicate a new direction or a significant shift is advisable. In these cases, it’s worthwhile to spend time helping managers understand the research, explain why it is wise to shift course, and explain how the business will benefit from the new path. As with any important business decision, managers must think deeply about the new approach and carefully map strategies, tactics, and available resources to plan effectively. By making the results available and accessible to managers and their execution teams, the marketing research project can serve as an ongoing guide and touchstone to help the organization plan, execute, and adjust course as it works toward desired goals and outcomes.

It is worth mentioning that many marketing research projects are never translated into management action. Sometimes this is because the report is too technical and difficult to understand. In other cases, the research conclusions fail to provide useful insights or solutions to the problem, or the report writer fails to offer specific suggestions for translating the research findings into management strategy. These pitfalls can be avoided by paying due attention to the research objectives throughout the project and allocating sufficient time and resources to do a good job interpreting research results for those who will need to act on them.

Bookends' new customer campaign

Your research findings and recommendations identified three segments for Bookends to focus on. Based on the demographics, lifestyle, and spending patterns found during your marketing research, you’re able to name them: 1) Bored Empty-Nesters, 2) Busy Families, and 3) Hipster Wannabes. Dan has a decent-sized clientele across all three groups, and they are pretty good spenders when they come in. But until now he hasn’t done much to purposely attract any of them.

With newly identified segments in focus, you and Dan begin brainstorming about a marketing mix to target each group. What types of books and other products would appeal to each one? What activities or events would bring them into the store? Are there promotions or particular messages that would induce them to buy at Bookends instead of Amazon or another bookseller? How will Dan reach and communicate with each group? And what can you do to bring more new customers into the store within these target groups?

Even though Bookends is a real-life project with serious consequences for your uncle Dan, it’s also a fun laboratory where you can test out some of the principles you’re learning in your marketing class. You’re figuring out quickly what it’s like to be a marketer.

Well done, rookie!

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1. Vincent P. Barabba, *Surviving Transformation: Lessons from GM's Surprising Turnaround*, pp 46–50, https://books.google.com/books?id=VvbDYad7cLoC&pg ↵
2. Proquest, "First We Built, Now We Buy: A Sociological Case Study for Enterprise Systems in Higher Education," pp 292–203
3. "The Role of Brand in the Nonprofit Sector: Four Case Studies," pp 1–7
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13.4: Marketing Mix Introduction

What you'll learn to do: explain the marketing mix

The value proposition explains why a consumer should buy a product or use a service and how the product or service will add more value, or better solve a problem, than other similar offerings. Once you get the value proposition right, you still have to actually deliver value to your target customer. The marketing mix describes the tools that marketers use to create value for customers.

Learning Objectives

- Define promotion
- Define price
- Evaluate how marketing strategies align with corporate strategies

Defining the Marketing Mix

Reaching Customers through the Marketing Mix

The value proposition is a simple, powerful statement of value, but it is only the tip of the iceberg. How do marketing professionals ensure that they are reaching and delivering value to the target customer?

Take yourself, as a "target customer." Think about your cell phone. What would make you want to buy a new one? How might the following issues affect your purchasing decision?

- Features: A company has just released a new phone with amazing features that appeal to you.
- Price: You're concerned about the price—is this phone a good deal? Too expensive? So cheap that you suspect there's a "catch"?
- Information: How did you find out about this phone? Did you see an ad? Hear about it from a friend? See pictures and comments about it online?
- Customer service: Is your cell service provider making it easier for you to buy this phone with a new plan or an upgrade?
- Convenience: Could you easily buy it online in a moment of indulgence?

You can see there are multiple factors that might influence your thinking and decision about what to buy—a *mix* of factors. Taken together, these factors are all part of the "marketing mix."

Organizations must find the right combination of factors that allow them to gain an advantage over their competitors. This combination—the marketing mix—is the combination of factors that a company controls to provide value to its target customers.

The following video illustrates how the marketing mix changes depending on the target customer:

Evolving Definitions of the Marketing Mix

There are a few different ways the marketing mix is presented. During the 1950s the components of the marketing mix were conceived as the “four Ps” and were defined as follows:

1. Product: the goods and services offered
2. Promotion: communication and information
3. Place: distribution or delivery
4. Price: ensuring fair value in the transaction[1]

Today, this categorization continues to be useful in understanding the basic activities associated with marketing. The marketing mix represents the way an organization’s broad marketing strategies are translated into marketing programs for action.

Over time, new categories of the marketing mix have been proposed. Most are more consumer oriented and attempt to better fit the movement toward a marketing orientation and a greater emphasis on customer value. One example is the four Cs, proposed by Robert F Lauterborn in 1990:

1. Customer solution: what the customer wants and needs
2. Communication: a two-way dialogue with the customer
3. Convenience: an easy process to act or buy
4. Cost: the customer’s cost to satisfy that want or need[2]

The four Cs include a greater focus on the customer but align nicely with the older four Ps. They also enable one to think about the marketing mix for services, not just products. While it is difficult to think about hotel accommodations as a distinct *product*, it is much easier to think about a hotel creating a *customer solution*. You can see how the four Ps compare with the four Cs in the chart below:

Four Ps	Four Cs	Definition
Product	Consumer solution	A company will only sell what the consumer specifically wants to buy. So, marketers should study consumer wants and needs in order to attract them one by one with something he/she wants to purchase.
Promotion	Communication	Communications can include advertising, public relations, personal selling, viral advertising, and any form of communication between the organization and the consumer.

Four Ps	Four Cs	Definition
Place	Convenience	In the era of Internet, catalogs, credit cards, and smartphones, often people don't have to go to a particular place to satisfy a want or a need, nor are they limited to a few places to satisfy them. Marketers should know how the target market prefers to buy, how to be there and be ubiquitous, in order to provide convenience of buying. With the rise of Internet and hybrid models of purchasing, "place" is becoming less relevant. Convenience takes into account the ease of buying the product, finding the product, finding information about the product, and several other factors.
Price	Cost	Price is only a part of the total cost to satisfy a want or a need. For example, the total cost might be the cost of time in acquiring a good or a service, along with the cost of conscience in consuming it. It reflects the total cost of ownership. Many factors affect cost, including but not limited to the customer's cost to change or implement the new product or service and the customer's cost for not selecting a competitor's product or service.

Whether we reference the four Ps or the four Cs, it is important to recognize that marketing requires attention to a range of different approaches and variables that influence customer behavior. Getting the right mix of activities is essential for marketing success.

Competitors and the Marketing Mix

The challenge of getting the right marketing mix is magnified by the existence of competitors, who exert market pressures using strategies defined by their marketing mix alternatives. Remember, the purpose of the marketing mix is to find the right combination of product, price, promotion, and distribution (place) so that a company can gain and maintain advantage over competitors.

Components of the Marketing Mix

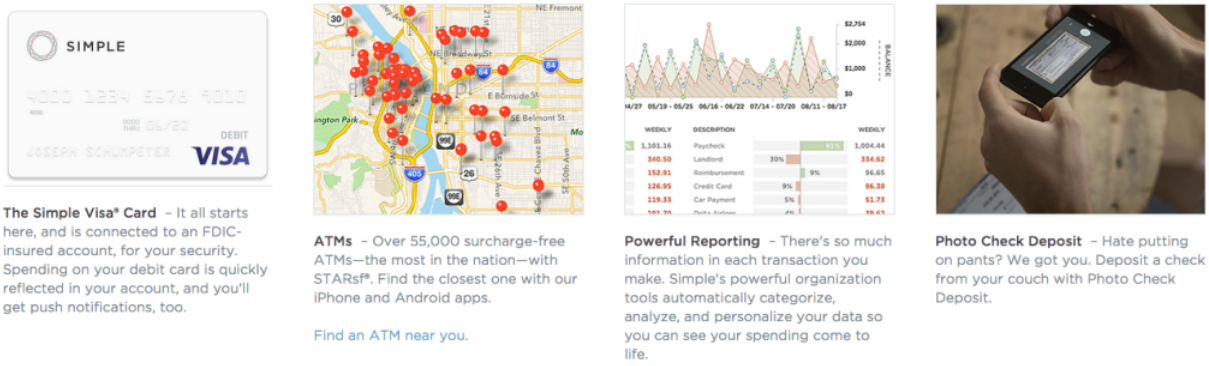
Product

In the marketing mix, the term "product" means the solution that the customer wants and needs. In this context, we focus on the solution rather than only on the physical product. Examples of the product include:

- The Tesla Model S, a premium electric car
- A Stay at a Holiday Inn Express, a low-price national hotel chain
- Doritos Nachos Cheese, a snack food
- Simple, an online banking service

Each of these products has a unique set of features, design, name, and brand that are focused on a target customer. The characteristics of the products are different from competitors' products.

All your finances, in your pocket or on the web, whenever you need it.



Source: https://www.simple.com/banking

Promotion

In the marketing mix, the term "promotion" refers to the communications that occur between the company and the customer. Promotion includes both the messages sent by the company and messages that customers send to the public about their experience. Examples of promotion include:

- An advertisement in Cooking Light magazine
- A customer's review of the product on Tumblr
- A newspaper article in the local paper quoting a company employee as an expert
- A test message sent to a list of customers or prospects

Marketing professionals have an increasingly difficult job influencing promotions that cannot be controlled by the company. The company's formal messages and advertising are only one part of promotions.

Marketers often run social media campaigns, rewarding customers who "Like" the company on Facebook.

Place

In the marketing mix, the term “place” refers to the distribution of the product. Where does the customer buy the product? “Place” might be a traditional brick-and-mortar store, or it could be online. Examples include:

- Distribution through an online retailer such as Amazon.com
- Use of a direct sales force that sells directly to buyers
- Sales through the company’s Web site, such as the shoe purchases at Nike.com
- Sales by a distributor or partner, such as the purchase of a Samsung phone from Best Buy or from a Verizon store

In today’s world, the concept of “place” in the marketing mix rarely refers to a specific physical address. It takes into account the broad range of distribution channels that make it easy for the target customer to buy.

Price

In the marketing mix, the term “price” refers to the cost to the customer. This requires the company to analyze the product’s value for the target customer. Examples of price include:

- The price of a used college textbook in the campus bookstore
- Promotional pricing such as Sonic Drive-In’s half-price cheeseburgers on Tuesdays
- Discounts to trade customers, such as furniture discounts for interior designers

Marketing professionals must analyze what buyers are willing to pay, what competitors are charging, and what the price means to the target customer when calculating the product’s value. Determining price is almost always a complicated analysis that brings together many variables.

Sonic offers discounts on cheeseburgers on Tuesday, which is typically a low sales day of the week. Source: www.sonicdrivein.com

Finding the Right Marketing Mix

How does an organization determine the right marketing mix? The answer depends on the organization's goals. Think of the marketing mix as a recipe that can be adjusted—through small adjustments or dramatic changes—to support broader company goals.

Decisions about the marketing-mix variables are interrelated. Each of the marketing mix variables must be coordinated with the other elements of the marketing program.

Consider, for a moment, the simple selection of hair shampoo. Let's think about three different brands of shampoo and call them Discount, Upscale, and Premium. The table below shows some of the elements of the marketing mix that impact decisions by target customers.

	Discount	**Upscale**	**Premium**
Product	Cleansing product, pleasant smell, low-cost packaging	Cleansing product, pleasant smell, attractive packaging	Cleansing product, pleasant smell created by named ingredients, premium packaging
Promotion	Few, if any, broad communications	National commercials show famous female "customers" with clean, bouncy hair	Differentiating features and ingredients highlighted (e.g., safe for colored hair), as well as an emphasis on the science behind the formula. Recommended by stylist in the salon.
Place	Distributed in grocery stores and drugstores	Distributed in grocery stores and drugstores	Distributed only in licensed salons
Price	Lowest price on the shelf	Highest price in the grocery store (8 times the prices of discount)	3 to 5 times the price of Upscale

A number of credible studies suggest that there is no difference in the effectiveness of Premium or Upscale shampoo compared with Discount shampoo, but the communication, distribution, and price are substantially different. Each product appeals to a very different target market. Do you buy your shampoo in a grocery store or a salon? Your answer is likely based on the marketing mix that has most influenced you.

An effective marketing mix centers on a target customer. Each element of the mix is evaluated and adjusted to provide unique value to the target customer. In our shampoo example, if the target market is affluent women who pay for expensive salon services, then reducing the price of a premium product might actually hurt sales, particularly if it leads stylists in salons to question the quality of the ingredients. Similarly, making the packaging more appealing for a discount product could have a negative impact if it increases the price even slightly or if it causes shoppers to visually confuse it with a more expensive product.

The goal with the marketing mix is to align marketing activities with the needs of the target customer.

Creating and Aligning the Marketing Strategy

Inputs That Inform Marketing Strategy

To a great extent, developing the marketing strategy follows the same sequence of activities used to define a corporate strategy. The chief difference is that the marketing strategy is directly affected by the overall corporate strategy; that is, the marketing strategy needs to work *with*—not apart from—the corporate strategy. As a result, the marketing strategy must always involve monitoring and reacting to changes in the corporate strategy and objectives.

In order to be effective, a marketing strategy must capitalize on the resources at its disposal *within* the company, but also take advantage of the market forces that are outside the company. One way to assess these different factors, or inputs, is by conducting a situation analysis (also called a SWOT analysis). As you recall, a SWOT analysis includes a review of the company's internal strengths and weaknesses and any external opportunities and threats that it faces.

Centering on the Target Customer

The **marketing strategy** defines how the marketing mix can best be used to achieve the corporate strategy and objectives. The centerpiece of the marketing strategy is the target customer. While the corporate strategy may have elements that focus on internal operations or seek to influence external forces, each component of the marketing strategy is focused on the target customer.

Recall the following steps of determining who your target customer is:

1. Identify the business need you will address, which will be driven by the corporate strategies and objectives;
2. Segment your total market, breaking down the market and identifying the subgroup you will target;
3. Profile your target customer, so that you understand how to provide unique value;
4. Research and validate your market opportunity.

Focusing the marketing strategy on the target customer seems like a no-brainer, but often organizations get wrapped up in their own strategies, initiatives, and products and forget to focus on the target customer. When this happens the customer loses faith in the product or the company and turns to alternative solutions.

Aligning Corporate and Marketing Strategies

Objectives can create alignment between corporate and marketing strategies. If the corporate objectives are clearly defined and communicated, they can guide and reinforce each step of the marketing planning process.

How would good corporate-level objectives inform the marketing strategy and objectives? Consider the following examples:

1. Imagine completing a market segmentation process. You find a target market that will find unique value in your offering. The decision to pursue that target market will depend on whether that segment is large enough to support the corporate objectives for market growth.
2. How many new products should the company launch this year? The answer should be informed by the corporate objectives for growth and profitability.
3. The marketing function has identified a customer relationship management campaign that would create greater customer loyalty. Does the cost of the campaign and its expected returns align with the company objectives?

As you can see, company objectives provide important guidance to the marketing planning process. Likewise, marketing objectives ensure that the goals of the marketing strategy are defined, communicated, and measured.

1. McCarthy, Jerome E. (1964). *Basic Marketing. A Managerial Approach*. Homewood, IL: Irwin. ↵
2. Lauterborn, B. (1990). New Marketing Litany: *Four Ps Passé: C-Words Take Over*. Advertising Age, 61(41), 26. ↵

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13.5: Putting It Together- Marketing Function

Synthesis

On February 1, 2015, a notable event occurred in the history of television: 114.5 million Americans watched a football game on TV, making it the most watched television program in U.S. history. Are there really 114.5 million football fans in the United States? Probably not. Why did so many people watch? Answer: the commercials!

Advertisers paid $4.5 million for 30 seconds of commercial airtime during this event. That works out to $150,000 per second. What were those companies doing when they made the decision to spend so much money? Marketing!

This is of course an extreme example of marketing in action, but if you begin to look closely at the world around you, you'll find that companies' marketing efforts are everywhere. Why do you shop where you shop? Are you a Coke or a Pepsi drinker? Do you only purchase items when they are on sale? Is your keychain (real or virtual) full of customer-loyalty cards? Marketing efforts are at work practically every time a customer perceives the value of a product or service and decides to swap some hard-earned money for it. Such marketing triumphs are just not the happy result of arbitrary circumstances, though—they're the product of strategic planning and research. Understanding how marketing efforts are created and conducted can help you be a better-informed consumer of products, goods, services, and information.

Summary

This module covered the marketing function and its contributions to business success. Below is a summary of the topics covered in this module.

Role of Customers

All marketing centers on creating, delivering, and communicating value to the customer. A value proposition is a clear and succinct statement to the customer of the value being offered by a company's products or services.

Segmentation and Targeting

One of the first steps in effective marketing is identifying and reaching the right customers. Marketers use segmentation and targeting to do this. Market segmentation is the process of splitting buyers into distinct, measurable groups that share similar wants and needs. Common segmentation approaches include geographic, demographic, psychographic, and behavioral criteria. Once different segments are identified, marketers determine which target segments to focus on to support corporate strategy and growth.

Marketing Mix Introduction

There are multiple factors that can influence someone's thinking and decision about what to buy—a *mix* of factors. Taken together, these factors are all part of the "marketing mix." The marketing mix, also known as the four Ps, is represented by the four main factors below:

1. Product: the goods and services offered
2. Promotion: communication and information
3. Place: distribution or delivery
4. Price: ensuring fair value in the transaction

A major part of marketing is getting the marketing mix right for the target customer.

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CHAPTER OVERVIEW

14: Marketing Mix

14.1: Why It Matters - Marketing Mix
14.2: Product
14.3: Promotion
14.4: Place
14.5: Price
14.6: Putting It Together- Marketing Mix

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14.1: Why It Matters - Marketing Mix

Why explain how organizations use the marketing mix to market to their target customers?

Why did Red Bull sponsor Felix Baumgartner's record-breaking free fall from outer space? Why does Anheuser-Busch pay millions of dollars for a 30-second television during the Superbowl? Why does Verizon Wireless put its name on concert venues and amphitheaters around the country? Think about these three examples and how appropriate the strategy is to the target market. Energy drinks and skydiving are a great matchup, and football and beer are a natural fit. What about cell phones and concerts, though? Who goes to concerts? The same people who have the heaviest cellular phone usage—teenagers and young adults. There is a method to all of this madness we call marketing. In short, all of these companies have determined that their efforts, although costly, support a marketing strategy that will give them the highest return on their marketing dollars and reach their target customers most effectively. Using an appropriate quantity of each component of what we refer to as the "marketing mix" helps businesses meet their sales goals. This is what we will explore in depth in the coming readings.

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14.2: Product

What you'll learn to do: explain common product marketing strategies and how organizations use them

Often when we hear the word *marketing*, we think about promotion or perhaps only advertising, but product is the core of the marketing mix. Product defines what will be priced, promoted, and distributed. If you are able to create and deliver a product that provides exceptional value to your target customer, the rest of the marketing mix is easier to manage. A successful product makes every aspect of a marketer's job easier—and more fun.

Learning Objectives

- Explain the elements and benefits of branding
- Describe the product life cycle
- Explain the stages of the new-product development process

Consumer Product Categories

A product is a bundle of attributes (features, functions, benefits, and uses) that a person receives in an exchange. In essence, the term "product" refers to anything offered by a firm to provide customer satisfaction, tangible or intangible. Thus, a product may be an idea (recycling), a physical good (a pair of sneakers), a service (banking), or any combination of the three.[1]

Broadly speaking, products fall into one of two categories: consumer products and business products (also called industrial products and B2B products). Consumer products are purchased by the final consumer. Business products are purchased by other industries or firms and can be classified as *production goods*—i.e., raw materials or component parts used in the production of the final product—or *support goods*—such as machinery, fixed equipment, software systems, and tools that assist in the production process.[2] Some products, like computers, for instance, may be both consumer products and business products, depending on who purchases and uses them.

The product fills an important role in the marketing mix because it is the core of the exchange. Does the product provide the features, functions, benefits, and uses that the target customer expects and desires? Throughout our discussion of product we will focus on the target customer. Often companies become excited about their capabilities, technologies, and ideas and forget the perspective of the customer. This leads to investments in product enhancements or new products that don't provide value to the customer—and, as a result, are unsuccessful.

Consumer products are often classified into four groups related to different kinds of buying decisions: convenience, shopping, specialty, and unsought products. These are described below.

Convenience Products

A convenience product is an inexpensive product that requires a minimum amount of effort on the part of the consumer in order to select and purchase it. Examples of convenience products are bread, soft drinks, pain reliever, and coffee. They also include headphones, power cords, and other items that are easily misplaced.

From the consumer's perspective, little time, planning, or effort go into buying convenience products. Often product purchases are made on impulse, so availability is important. Consumers have come to expect a wide variety of products to be conveniently located at their local supermarkets. They also expect easy online purchase options and low-cost, quick shipping for those purchases. Convenience items are also found in vending machines and kiosks.

For convenience products, the primary marketing strategy is extensive distribution. The product must be available in every conceivable outlet and must be easily accessible in these outlets. These products are usually of low unit value, and they are highly standardized. Marketers must establish a high level of brand awareness and recognition. This is accomplished through extensive mass advertising, sales promotion devices such as coupons and point-of-purchase displays, and effective packaging. Yet, the key is to convince resellers (wholesalers and retailers) to carry the product. If the product is not available when, where, and in a form the consumer desires, the convenience product will fail.

Shopping Products

In contrast, consumers want to be able to compare products categorized as shopping products. Shopping products are usually more expensive and are purchased occasionally. The consumer is more likely to compare a number of options to assess quality, cost, and features.

Although many shopping goods are nationally advertised, in the marketing strategy it is often the ability of the retailer to differentiate itself that generates the sale. If you decide to buy a TV at BestBuy, then you are more likely to evaluate the range of options and prices that BestBuy has to offer. It becomes important for BestBuy to provide a knowledgeable and effective sales person and have the right pricing discounts to offer you a competitive deal. BestBuy might also offer you an extended warranty package or in-store service options. While shopping in BestBuy, consumers can easily check prices and options for online retailers, which places even greater pressure on BestBuy to provide the best total value to the shopper. If the retailer can't make the sale, product turnover is slower, and the retailer will have a great deal of their capital tied up in inventory.

There is a distinction between heterogeneous and homogeneous shopping products. Heterogeneous shopping products are unique. Think about shopping for clothing or furniture. There are many stylistic differences, and the shopper is trying to find the best stylistic match at the right price. The purchase decision with heterogeneous shopping products is more likely to be based on finding the right fit than on price alone.

In contrast, homogeneous shopping products are very similar. Take, for example, refrigerators. Each model has certain features that are available at different price points, but the basic functions of all of the models are very similar. A typical shopper will look for the lowest price available for the features that they desire.

Specialty Products

Specialty goods represent the third product classification. From the consumer's perspective, these products are so unique that it's worth it to go to great lengths to find and purchase them. Almost without exception, price is not the principle factor affecting the sales of specialty goods. Although these products may be custom-made or one-of-a-kind, it is also possible that the marketer has been very successful in differentiating the product in the mind of the consumer.

Blizzcon attendees, 2014

For example, some consumers feel a strong attachment to their hair stylist or barber. They are more likely to wait for an appointment than schedule time with a different stylist.

Another example is the annual Blizzcon event produced by Blizzard Entertainment. The $200 tickets sell out minutes after they are released, and they are resold at a premium. At the event, attendees get the chance to learn about new video games and play games that have not yet been released. They can also purchase limited-edition promotional items. From a marketer's perspective, in Blizzcon the company has succeeded in creating a specialty product that has incredibly high demand. Moreover, Blizzard's customers are paying for the opportunity to be part of a massive marketing event.

It is generally desirable for a marketer to lift her product from the shopping to the specialty class—and keep it there. With the exception of price-cutting, the entire range of marketing activities is needed to accomplish this.

Unsought Products

Unsought products are those the consumer never plans or hopes to buy. These are either products that the customer is unaware of or products the consumer hopes not to need. For example, most consumers hope never to purchase pest control services and try to avoid purchasing funeral plots. Unsought products have a tendency to draw aggressive sales techniques, as it is difficult to get the attention of a buyer who is not seeking the product.

Elements and Benefits of Branding

What Is a Brand?

As we start our exploration of brand and its role in marketing, take a few minutes to watch the following video about Coca-Cola, which is perhaps one of the most iconic brands of all time. As you watch this video, look and listen for the all the different elements that contribute to the thing we call a "brand."

Click here to read a transcript of the video.

Brands are interesting, powerful concoctions of the marketplace that create tremendous value for organizations and for individuals. Because brands serve several functions, we can define the term “brand” in the following ways:

1. **A brand is an identifier:** a name, sign, symbol, design, term, or some combination of these things that identifies an offering and helps simplify choice for the consumer.
2. **A brand is a promise:** the promise of what a company or offering will provide to the people who interact with it.
3. **A brand is an asset:** a reputation in the marketplace that can drive price premiums and customer preference for goods from a particular provider.
4. **A brand is a set of perceptions:** the sum total of everything individuals believe, think, see, know, feel, hear, and experience about a product, service, or organization.
5. **A brand is “mind share”:** the unique position a company or offering holds in the customer’s mind, based on their past experiences and what they expect in the future.

A brand consists of all the features that distinguish the goods and services of one seller from another: name, term, design, style, symbols, customer touch points, etc. Together, all elements of the brand work as a psychological trigger or stimulus that causes an association to all other thoughts one has had about this brand.

Brands are a combination of tangible and intangible elements, such as the following:

- Visual design elements (i.e., logo, color, typography, images, tagline, packaging, etc.)
- Distinctive product features (i.e. quality, design sensibility, personality, etc.)
- Intangible aspects of customers’ experience with a product or company (i.e. reputation, customer experience, etc.)

Branding–the act of creating or building a brand–may take place at multiple levels: company brands, individual product brands, or branded product lines. Any entity that works to build consumer loyalty can also be considered a brand, such as celebrities (Lady Gaga, e.g.), events (Susan G. Komen Race for the Cure, e.g.), and places (Las Vegas, e.g.).

Brands Create Market Perceptions

A successful brand is much more than just a name or logo. As suggested in one of the definitions above, brand is the sum of perceptions about a company or product in the minds of consumers. Effective brand building can create and sustain a strong, positive, and lasting impression that is difficult to displace. Brands provide external cues to taste, design, performance, quality, value, or other desired attributes if they are developed and managed properly. Brands convey positive or negative messages about a

company, product, or service. Brand perceptions are a direct result of past advertising, promotion, product reputation, and customer experience.

A brand can convey multiple levels of meaning, including the following:

As an automobile brand, the Mercedes-Benz logo suggests high prestige.

1. **Attributes**: specific product features. The Mercedes-Benz brand, for example, suggests expensive, well-built, well-engineered, durable vehicles.
2. **Benefits**: attributes translate into functional and emotional benefits. Mercedes automobiles suggest prestige, luxury, wealth, reliability, self-esteem.
3. **Values**: company values and operational principles. The Mercedes brand evokes company values around excellence, high performance, power.
4. **Culture**: cultural elements of the company and brand. Mercedes represents German precision, discipline, efficiency, quality.
5. **Personality**: strong brands often project a distinctive personality. The Mercedes brand personality combines luxury and efficiency, precision and prestige.
6. **User**: brands may suggest the types of consumers who buy and use the product. Mercedes drivers might be perceived and classified differently than, for example, the drivers of Cadillacs, Corvettes, or BMWs.

Brands Create an Experience

Effective branding encompasses everything that shapes the perception of a company or product in the minds of customers. Names, logos, brand marks, trade characters, and trademarks are commonly associated with brand, but these are just part of the picture. Branding also addresses virtually every aspect of a customer's experience with a company or product: visual design, quality, distinctiveness, purchasing experience, customer service, and so forth. Branding requires a deep knowledge of customers and how they experience the company or product. Brand-building requires long-term investment in communicating about and delivering the unique value embodied in a company's "brand," but this effort can bring long-term rewards.

In consumer and business-to-business markets, branding can influence whether consumers will buy the product and how much they are willing to pay. Branding can also help in new product introduction by creating meaning, market perceptions, and differentiation where nothing existed previously. When companies introduce a new product using an existing brand name (a brand extension or a branded product line), they can build on consumers' positive perceptions of the established brand to create greater receptivity for the new offering.

Brands Create Value

The Dunkin' Donuts logo, which includes an image of a DD cup of coffee, makes it easy to spot anywhere. The coffee is known for being a good value at a great price.

Brands create value for consumers and organizations in a variety of ways.

Value of Branding for the Consumer

Brands help simplify consumer choices. Brands help create trust, so that a person knows what to expect from a branded company, product, or service. Effective branding enables the consumer to easily identify a desirable company or product because the features and benefits have been communicated effectively. Positive, well-established brand associations increase the likelihood that consumers will select, purchase, and consume the product. Dunkin' Donuts, for example, has an established logo and imagery familiar to many U.S. consumers. The vivid colors and image of a DD cup are easily recognized and distinguished from competitors, and many associate this brand with tasty donuts, good coffee, and great prices.

Value of Branding for Product and Service Providers

The Starbucks brand is associated with premium, high-priced coffee.

For companies and other organizations that produce goods, branding helps create loyalty. It decreases the risk of losing market share to the competition by establishing a competitive advantage customers can count on. Strong brands often command premium pricing from consumers who are willing to pay more for a product they know, trust, and perceive as offering good value. Branding can be a great vehicle for effectively reaching target audiences and positioning a company relative to the competition. Working in conjunction with positioning, brand

is the ultimate touchstone to guide choices around messaging, visual design, packaging, marketing, communications, and product strategy.

For example, Starbucks' loyal fan base values and pays premium prices for its coffee. Starbucks' choices about beverage products, neighborhood shops, the buying experience, and corporate social responsibility all help build the Starbucks brand and communicate its value to a global customer base.

Value of Branding for the Retailer

Retailers such as Target, Safeway, and Walmart create brands of their own to create a loyal base of customers. Branding enables these retailers to differentiate themselves from one another and build customer loyalty around the unique experiences they provide. Retailer brand building may focus around the in-store or online shopping environment, product selection, prices, convenience, personal service, customer promotions, product display, etc.

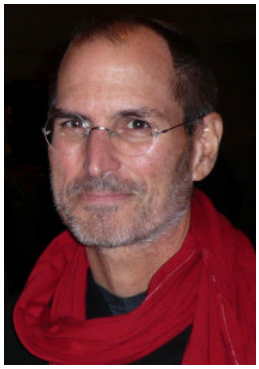
Retailers also benefit from carrying the branded products customers want. Brand-marketing support from retailers or manufacturers can help attract more customers (ideally ones who normally don't frequent an establishment). For example, a customer who truly values organic brands might decide to visit a Babies R Us to shop for organic household cleaners that are safe to use around babies. This customer might have learned that a company called BabyGanics, which brands itself as making "safe, effective, natural household solutions," was only available at this particular retailer.

Common Branding Strategies

Managing Brands As Strategic Assets

As organizations establish and build strong brands, they can pursue a number of strategies to continue developing them and extending their value to stakeholders (customers, retailers, supply chain and distribution partners, and of course the organization itself).

Brand Ownership



Steve Jobs, co-founder and CEO of Apple

Who "owns" the brand? The legal owner of a brand is generally the individual or entity in whose name the legal registration has been filed. Operationally speaking, brand ownership should be the responsibility of an organization's management and employees. Brand ownership is about building and maintaining a brand that reflects your principles and values. Brand *building* is about effectively persuading customers to believe in and purchase your product or service. Iconic brands, such as Apple and Disney, often have a history of visionary leaders who champion the brand, evangelize about it, and build it into the organizational culture and operations.

Branding Strategies

A branding strategy helps establish a product within the market and to build a brand that will grow and mature. Making smart branding decisions up front is crucial since a company may have to live with their decisions for a long time. The following are commonly used branding strategies:

"Branded House" Strategy

A "branded house" strategy (sometimes called a "house brand") uses a strong brand—typically the company name—as the identifying brand name for a range of products (for example, Mercedes Benz or Black & Decker) or a range of subsidiary brands (such as Cadbury Dairy Milk or Cadbury Fingers). Because the primary focus and investment is in a single, dominant "house" brand, this approach can be simpler and more cost effective in the long run when it is well aligned with broader corporate strategy.

"House of Brands" Strategy

Kool-Aid Man

With the "house of brands" strategy, a company invests in building out a variety of individual, product-level brands. Each of these brands has a separate name and may not be associated with the parent company name at all. These brands may even be in de facto competition with other brands from the same company. For example, Kool-Aid and Tang are two powdered beverage products, both owned by Kraft Foods. The "house of brands" strategy is well suited to companies that operate across many product categories at the same time. It allows greater flexibility to introduce a variety of different products, of differing quality, to be sold without confusing the consumer's perception of what business the company is in or diluting brand perceptions about products that

target different tiers or types of consumers within the same product category.

Private-Label or Store Branding

Also called store branding, private-label branding has become increasingly popular. In cases where the retailer has a particularly strong identity, the private label may be able to compete against even the strongest brand leaders and may outperform those products that are not otherwise strongly branded. The northeastern U.S. grocery chain Wegman's offers many grocery products that carry the Wegman's brand name. Meanwhile national grocery chain Safeway offers several different private label "store" brands: Safeway Select, Organics, Signature Cafe, and Primo Taglio, among others.[3]

"No-Brand" Branding

A number of companies successfully pursue "no-brand" strategies by creating packaging that imitates generic-brand simplicity. "No brand" branding can be considered a type of branding since the product is made conspicuous by the absence of a brand name. "Tapa Amarilla" or "Yellow Cap" in Venezuela during the 1980s is a prime example of no-brand strategy. It was recognized simply by the color of the cap of this cleaning products company.

Personal and Organizational Brands

Personal and organizational branding are strategies for developing a brand image and marketing engine around individual people or groups. Personal branding treats persons and their careers as products to be branded and sold to target audiences. Organizational branding promotes the mission, goals, and/or work of the group being branded. The music and entertainment industries provide many examples of personal and organizational branding. From Justin Bieber to George Clooney to Kim Kardashian, virtually any celebrity today is a personal brand. Likewise, bands, orchestras, and other artistic groups typically cultivate an organizational (or group) brand. Faith branding is a variant of this brand strategy, which treats religious figures and organizations as brands seeking to increase their following. Mission-driven organizations such the Girl Scouts of America, the Sierra Club, the National Rifle Association (among millions of others) pursue organizational branding to expand their membership, resources, and impact.

Place Branding

The developing fields of place branding and nation branding work on the assumption that places compete with other places to win over people, investment, tourism, economic development, and other resources. With this in mind, public administrators, civic leaders, and business groups may team up to "brand" and promote their city, region, or nation among target audiences. Depending on the goals they are trying to achieve, targets for these marketing initiatives may be real-estate developers, employers and business investors, tourists and tour/travel operators, and so forth. While place branding may focus on any given geographic area or destination, nation branding aims to measure, build, and manage the reputation of countries.

The city-state Singapore is an early, successful example of nation branding. The edgy Las Vegas "What Happens Here, Stays Here" campaign, shown in in the following video, is a well-known example of place branding.

Co-Branding

Co-branding is an arrangement in which two established brands collaborate to offer a single product or service that carries both brand names. In these relationships, generally both parties contribute something of value to the new offering that neither would have been able to achieve independently. Effective co-branding builds on the complementary strengths of the existing brands. It can also allow each brand an entry point into markets in which they would not otherwise be credible players.

The following are some examples of co-branded offerings:

- Delta Airlines and American Express offer an entire family of co-branded credit cards; other airlines offer similar co-branded cards that offer customer rewards in terms of frequent flyer points and special offers.

Fiat 500 "Barbie"

- Home furnishings company Pottery Barn and the paint manufacturer Benjamin Moore co-brand seasonal color palettes for home interior paints
- Fashion designer Liz Lange designs a ready-to-wear clothing line co-branded with and sold exclusively at Target stores
- Auto maker Fiat and toy maker Mattel teamed up to celebrate Barbie's fiftieth anniversary with the nail-polish-pink Fiat 500 Barbie car.

Co-branding is a common brand-building strategy, but it can present difficulties. There is always risk around how well the market will receive new offerings, and sometimes, despite the best-laid plans, co-branded offerings fall flat. Also, these arrangements often involve complex legal agreements that are difficult to implement. Co-branding relationships may be unevenly matched, with the partners having different visions for their collaboration, placing different priority on the importance of the co-branded venture, or one partner holding significantly more power than the other in determining how they work together. Because co-branding impacts the existing brands, the partners may struggle with how to protect their current brands while introducing something new and possibly risky.

Brand Licensing

Campbell's "Star Wars" Soup. Source: http://www.campbells.com/star-wars/

Brand licensing is the process of leasing or renting the right to use a brand in association with a product or set of products for a defined period and within a defined market, geography, or territory. Through a licensing agreement, a firm (licensor) provides some tangible or intangible asset to another firm (licensee) and grants that firm the right to use the licensor's brand name and related brand assets in return for some payment. The licensee obtains a competitive advantage in this arrangement, while the licensor obtains inexpensive access to the market in question.

Licensing can be extremely lucrative for the owner of the brand, as other organizations pay for permission to produce products carrying a licensed name. The Walt Disney Company was an early pioneer in brand licensing, and it remains a leader in this area with its wildly popular entertainment and toy brands: Star Wars, Disney Princesses, Toy Story, Mickey Mouse, and so on. Toy manufacturers, for example, pay millions of dollars and vie for the rights to produce and sell products affiliated with these "super-brands."

Line Extensions and Brand Extensions

Organizations use line extensions and brand extensions to leverage and increase brand equity.

Diet Coke is a line extension of the Coke brand.

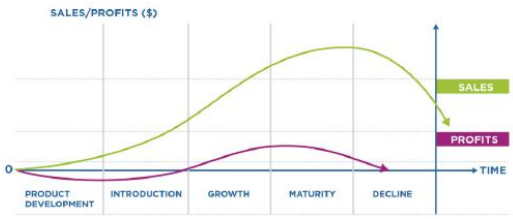
A company creates a **line extension** when it introduces a new variety of offering within the same product category. To illustrate with the food industry, a company might add new flavors, package sizes, nutritional content, or products containing special additives in line extensions. Line extensions aim to provide more variety and hopefully capture more of the market within a given category. More than half of all new products introduced each year are line extensions. For example, M&M candy varieties such as peanut, pretzel, peanut butter, and dark chocolate are all line extensions of the M&M brand. Diet Coke™ is a line extension of the parent brand Coke ™. While the products have distinct differences, they are in the same product category.

A **brand extension** moves an existing brand name into a new product category, with a new or somehow modified product. In this scenario, a company uses the strength of an established product to launch a product in a different category, hoping the popularity of the original brand will increase receptivity of the new product. An example of a brand extension is the offering of Jell-O pudding pops in addition to the original product, Jell-O gelatin. This strategy increases awareness of the brand name and increases profitability from offerings in more than one product category.

Line extensions and brand extensions are important tools for companies because they reduce financial risk associated with new-product development by leveraging the equity in the parent brand name to enhance consumers' perceptions and receptivity towards new products. Due to the established success of the parent brand, consumers will have instant recognition of the product name and be more likely to try the new line extension.

Stages of the Product Life Cycle

A company has to be good at both developing new products and managing them in the face of changing tastes, technologies, and competition. Products generally go through a life cycle with predictable sales and profits. Marketers use the product life cycle to follow this progression and identify strategies to influence it. The product life cycle (PLC) starts with the product's development and introduction, then moves toward withdrawal or eventual demise. This progression is shown in the graph, below.



PRODUCT LIFE CYCLE

The five stages of the PLC are:

1. Product development
2. Market introduction
3. Growth
4. Maturity
5. Decline

The table below shows common characteristics of each stage.

Common Characteristics	
0. Product development stage	1. investment is made 2. sales have not begun 3. new product ideas are generated, operationalized, and tested

1. Market introduction stage	1. costs are very high 2. slow sales volumes to start 3. little or no competition 4. demand has to be created 5. customers have to be prompted to try the product 6. makes little money at this stage
2. Growth stage	1. costs reduced due to economies of scale 2. sales volume increases significantly 3. profitability begins to rise 4. public awareness increases 5. competition begins to increase with a few new players in establishing market 6. increased competition leads to price decreases
3. Maturity stage	1. costs are lowered as a result of increasing production volumes and experience curve effects 2. sales volume peaks and market saturation is reached 3. new competitors enter the market 4. prices tend to drop due to the proliferation of competing products 5. brand differentiation and feature diversification is emphasized to maintain or increase market share 6. profits decline
4. Decline stage	1. costs increase due to some loss of economies of scale 2. sales volume declines 3. prices and profitability diminish 4. profit becomes more a challenge of production/distribution efficiency than increased sales

Using the Product Life Cycle

The product life cycle can be a useful tool in planning for the life of the product, but it has a number of limitations.

Not all products follow a smooth and predictable growth path. Some products are tied to specific business cycles or have seasonal factors that impact growth. For example, enrollment in higher education tracks closely with economic trends. When there is an economic downturn, more people lose jobs and enroll in college to improve their job prospects. When the economy improves and more people are fully employed, college enrollments drop. This does not necessarily mean that education is in decline, only that it is in a down cycle.

Furthermore, evidence suggests that the PLC framework holds true for industry segments but not necessarily for individual brands or projects, which are likely to experience greater variability.[4]

Of course, changes in other elements of the marketing mix can also affect the performance of the product during its life cycle. Change in the competitive situation during each of these stages may have a much greater impact on the marketing approach than the PLC itself. An effective promotional program or a dramatic lowering of price may improve the sales picture in the decline period, at least temporarily. Usually the improvements brought about by non-product tactics are relatively short-lived, and basic alterations to product offerings provide longer benefits.

Whether one accepts the S-shaped curve as a valid sales pattern or as a pattern that holds only for some products (but not for others), the PLC concept can still be very useful. It offers a framework for dealing systematically with product marketing issues and activities. The marketer needs to be aware of the generalizations that apply to a given product as it moves through the various stages.

Marketing through the Product Cycle

There are some common marketing considerations associated with each stage of the PLC. How marketers think about the marketing mix and the blend of promotional activities–also known as the promotion mix–should reflect a product's life-cycle stage

and progress toward market adoption. These considerations cannot be used as a formula to guarantee success, but they can function as guidelines for thinking about budget, objectives, strategies, tactics, and potential opportunities and threats.

Keep in mind that we will discuss the new-product development process next, so it is not covered here.

Market Introduction Stage

Think of the market introduction stage as the product launch. This phase of the PLC requires a significant marketing budget. The market is not yet aware of the product or its benefits. Introducing a product involves convincing consumers that they have a problem or need which the new offering can uniquely address. At its core, messaging should convey, "This product is a great idea! You want this!" Usually a promotional budget is needed to create broad awareness and educate the market about the new product. To achieve these goals, often a product launch includes promotional elements such as a new Web site (or significant update to the existing site), a press release and press campaign, and a social media campaign.

There is also a need to invest in the development of the distribution channels and related marketing support. For a B2B product, this often requires training the sales force and developing sales tools and materials for direct and personal selling. In a B2C market, it might include training and incentivizing retail partners to stock and promote the product.

Pricing strategies in the introduction phase are generally set fairly high, as there are fewer competitors in the market. This is often offset by early discounts and promotional pricing.

Google Glass

It is worth noting that the launch will look different depending on how new the product is. If the product is a completely new innovation that the market has not seen before, then there is a need to both educate the market about the new offering and build awareness of it. In 2013 when Google launched Google Glass—an optical head-mounted computer display—it had not only to get the word out about the product but also help prospective buyers understand what it was and how it might be used. Google initially targeted tech-savvy audiences most interested in novelty and innovation (more about them later when we discuss *diffusion of innovation*). By offering the new product with a lot of media fanfare and limited availability, Google's promotional strategy ignited demand among these segments. Tech bloggers and insiders blogged and tweeted about their Google Glass adventures, and word-of-mouth sharing about the new product spread rapidly. You can imagine that this was very different from the launch of Wheat Thins Spicy Buffalo crackers, an extension of an existing product line, targeting a different audiences (retailers, consumers) with promotional activities that fit the product's marketing and distribution channels. The Google Glass situation was also different from the launch of Tesla's home battery. In that case Tesla offered a new line of home products from a company that had previously only offered automobiles. Breaking into new product categories and markets is challenging even for a well-regarded company like Tesla. As you might expect, the greater the difference in new products from a company's existing offerings, the greater the complexity and expense of the introduction stage.

One other consideration is the maturity of the product. Sometimes marketers will choose to be conservative during the marketing introduction stage when the product is not yet fully developed or proven, or when the distribution channels are not well established. This might mean initially introducing the product to only one segment of the market, doing less promotion, or limiting distribution (as with Google Glass). This approach allows for early customer feedback but reduces the risk of product issues during the launch.

While we often think of an introduction or launch as a single event, this phase can last several years. Generally a product moves out of the introduction stage when it begins to see rapid growth, though what counts as "rapid growth" varies significantly based on the product and the market.

Growth Stage

Once rapid growth begins, the product or industry has entered the growth stage. When a product category begins to demonstrate significant growth, the market usually responds: new competitors enter the market, and larger companies acquire high-growth companies and products.

These emerging competitive threats drive new marketing tactics. Marketers who have been seeking to build broad market awareness through the introduction phase must now differentiate their products from competitors, emphasizing unique features that appeal to target customers. The central thrust of market messaging and promotion during this stage is "This brand is the best!" Pricing also becomes more competitive and must be adjusted to align with the differentiation strategy.

Often in the growth phase the marketer must pay significant attention to distribution. With a growing number of customers seeking the product, more distribution channels are needed. Mass marketing and other promotional strategies to reach more customers and segments start to make sense for consumer-focused markets during the growth stage. In business-to-business markets, personal selling and sales promotions often help open doors to broader growth. Marketers often must develop and support new distribution channels to meet demand. Through the growth phase, distribution partners will become more experienced selling the product and may require less support over time.

The primary challenges during the growth phase are to identify a differentiated position in the market that allows the product to capture a significant portion of the demand and to manage distribution to meet the demand.

Maturity Stage

When growth begins to plateau, the product has reached the maturity phase. In order to achieve strong business results through the maturity stage, the company must take advantage of economies of scale. This is usually a period in which marketers manage budget carefully, often redirecting resources toward products that are earlier in their life cycle and have higher revenue potential.

At this stage, organizations are trying to extract as much value from an established product as they can, typically in a very competitive field. Marketing messages and promotions seek to remind customers about a great product, differentiate from competitors, and reinforce brand loyalty: “Remember why this brand is the best.” As mentioned in the previous section, this late in the life cycle, promotional tactics and pricing discounts are likely to provide only short-term benefits. Changes to product have a better chance of yielding more sustained results.

In the maturity stage, marketers often focus on niche markets, using promotional strategies, messaging, and tactics designed to capture new share in these markets. Since there is no new growth, the emphasis shifts from drawing new customers to the market to winning more of the existing market. The company may extend a product line, adding new models that have greater appeal to a smaller segment of the market.

Often, distribution partners will reduce their emphasis on mature products. A sales force will shift its focus to new products with more growth potential. A retailer will reallocate shelf space. When this happens the manufacturer may need to take on a stronger role in driving demand.

We have repeatedly seen this tactic in the soft drink industry. As the market has matured, the number of different flavors of large brands like Coke and Pepsi has grown significantly. We will look at other product tactics to extend the growth phase and manage the maturity phase in the next section.

Decline Stage

Once a product or industry has entered decline, the focus shifts almost entirely to eliminating costs. Little if any marketing spending goes into products in this life stage, because the marketing investment is better spent on other priorities. For goods, distributors will seek to eliminate inventory by cutting prices. For services, companies will reallocate staff to ensure that delivery costs are in check. Where possible, companies may initiate a planned obsolescence process. Commonly technology companies will announce to customers that they will not continue to support a product after a set obsolescence date.

Often a primary focus for marketers during this stage is to transition customers to newer products that are earlier in the product life cycle and have more favorable economics. Promotional activities and marketing communications, if any, typically focus on making this transition successful among brand-loyal segments who still want the old product. A typical theme of marketing activity is “This familiar brand is still here, but now there’s something even better.”

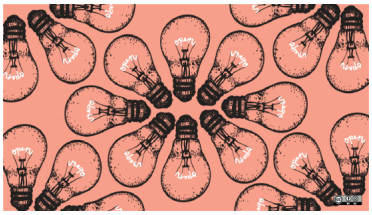
The New-Product Development Process

There are probably as many varieties of new-product development systems as there are types of companies, but most of them share the same basic steps or stages—they are just executed in different ways. Below, we have divided the process into eight stages, grouped into three phases. Many of the activities are performed repeatedly throughout the process, but they become more concrete as the product idea is refined and additional data are gathered. For example, at each stage of the process, the product team is asking, “Is this a viable product concept?” but the answers change as the product is refined and more market perspectives can be added to the evaluation.

Phase I: Generating and Screening Ideas	Phase II: Developing New Products	Phase III: Commercializing New Products

Phase I: Generating and Screening Ideas	Phase II: Developing New Products	Phase III: Commercializing New Products
Stage 1: Generating New Product Ideas	Stage 4: Business Case Analysis	Stage 6: Test Marketing
Stage 2: Screening Product Ideas	Stage 5: Technical and Marketing Development	Stage 7: Launch
Stage 3: Concept Development and Testing		

Stage 1: Generating New Product Ideas



Generating new product ideas is a creative task that requires a particular way of thinking. Coming up with ideas is easy, but generating good ideas is another story. Companies use a range of internal and external sources to identify new product ideas. A SWOT analysis might suggest strengths in existing products that could be the basis for new products or market opportunities. Research might identify market and customer trends. A competitive analysis might expose a hole in the company's product portfolio. Customer focus groups or the sales team might identify unmet customer needs. Many amazing products are also the result of lucky mistakes—product experiments that don't meet the intended goal but have an unintended and interesting application. For example, 3M scientist Dr. Spencer Silver invented Post-It Notes in a failed experiment to create a super-strong adhesive.[5]

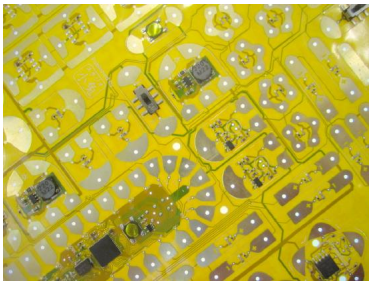
The key to the idea generation stage is to explore possibilities, knowing that most will not result in products that go to market.

Stage 2: Screening Product Ideas

The second stage of the product development process is idea screening. This is the first of many screening points. At this early stage much is *not* known about the product and its market opportunity. Still, product ideas that do not meet the organization's objectives should be rejected at this stage. If a poor product idea is allowed to pass the screening stage, it wastes effort and money in later stages until it is abandoned. Even more serious is the possibility of screening out a worthwhile idea and missing a significant market opportunity. For this reason, this early screening stage allows many ideas to move forward that may not eventually go to market.

At this early stage, product ideas may simply be screened through some sort of internal rating process. Employees might rate the product ideas according to a set of criteria, for example; those with low scores are dropped and only the highest ranked products move forward.

Stage 3: Concept Development and Testing



Today, it is increasingly common for companies to run some small concept test in a real marketing setting. The *product concept* is a synthesis or a description of a product idea that reflects the core element of the proposed product. Marketing tries to have the most accurate and detailed product concept possible in order to get accurate reactions from target buyers. Those reactions can then be used to inform the final product, the marketing mix, and the business analysis.

New tools for technology and product development are available that support the rapid development of prototypes which can be tested with potential buyers. When concept testing can include an actual product prototype, the early test results are much more reliable. Concept testing helps companies avoid investing in bad ideas and at the same time helps them catch and keep outstanding product ideas.

Stage 4: Business Case Analysis

Before companies make a significant investment in a product's development, they need to be sure that it will bring a sufficient return.

The company seeks to answer such questions as the following:

1. What is the market opportunity for this product?
2. What are the costs to bring the product to market?
3. What are the costs through the stages of the product life cycle?
4. Where does the product fit in the product portfolio and how will it impact existing product sales?

5. How does this product impact the brand?
6. How does this product impact other corporate objectives such as social responsibility?

The marketing budget and costs are one element of the business analysis, but the full scope of the analysis includes all revenues, costs, and other business impacts of the product.

Stage 5: Technical and Marketing Development

A product that has passed the screening and business analysis stages is ready for technical and marketing development. Technical development processes vary greatly according to the type of product. For a product with a complex manufacturing process, there is a lab phase to create specifications and an equally complex phase to develop the manufacturing process. For a service offering, there may be new processes requiring new employee skills or the delivery of new equipment. These are only two of many possible examples, but in every case the company must define both what the product is and how it will be delivered to many buyers.

While the technical development is under way, the marketing department is testing the early product with target customers to find the best possible marketing mix. Ideally, marketing uses product prototypes or early production models to understand and capture customer responses and to identify how best to present the product to the market. Through this process, product marketing must prepare a complete marketing plan—one that starts with a statement of objectives and ends with a coherent picture of product distribution, promotion, and pricing integrated into a plan of marketing action.

Stage 6: Test Marketing and Validation

Test marketing is the final stage before commercialization; the objective is to test all the variables in the marketing plan including elements of the product. Test marketing represents an actual launching of the total marketing program. However, it is done on a limited basis.

Initial product testing and test marketing are not the same. Product testing is totally initiated by the producer: he or she selects the sample of people, provides the consumer with the test product, and offers the consumer some sort of incentive to participate.

Test marketing, on the other hand, is distinguished by the fact that the test group *represents* the full market, the consumer must make a purchase decision and pay for the product, and the test product must compete with the existing products in the actual marketing environment. For these and other reasons, a market test is an accurate simulation of the broader market and serves as a method for reducing risk. It should enhance the new product's probability of success and allow for final adjustment in the marketing mix before the product is introduced on a large scale.

Stage 7: Launch

Finally, the product arrives at the commercial launch stage. The marketing mix comes together to introduce the product to the market. This stage marks the beginning of the product life cycle.

Stage 8: Evaluation

The launch does not in any way signal the end of the marketing role for the product. To the contrary, after launch the marketer finally has real market data about how the product performs in the wild, outside the test environment. These market data initiate a new cycle of idea generation about improvements and adjustments that can be made to all elements of the marketing mix.

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1. www.ama.org/resources/Pages/...tter=P#product ↵
2. www.businessdictionary.com/de...ial-goods.html ↵
3. http://www.safeway.com/ShopStores/Br...ur-Brands.page ↵
4. Mullor-Sebastian, Alicia. "The Product Life Cycle Theory: Empirical Evidence." Journal of International Business Studies 14.3 (1983): 95–105. ↵
5. https://en.Wikipedia.org/wiki/Post-it_note ↵

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14.3: Promotion

What you'll learn to do: explain how organizations use integrated marketing communication (IMC) to support their marketing strategies

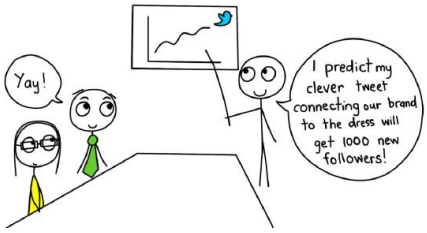
The readings in this section cover seven different marketing communication methods that are commonly used today. This section will help you become familiar with each method, common tools associated with each method, and the advantages and disadvantages of each one.

Learning Objectives

- Explain the promotion mix
- Explain how organizations use IMC to support their marketing strategies

Integrated Marketing Communication (IMC) Definition

IMC: Making an Impact with Marketing Communication



Having a great product available to your customers at a great price does absolutely nothing for you if your customers don't know about it. That's where promotion enters the picture: it does the job of connecting with your target audiences and communicating what you can offer them.

In today's marketing environment, promotion involves *integrated marketing communication* (IMC). In a nutshell, IMC involves bringing together a variety of different communication tools to deliver a common message and make a desired impact on customers' perceptions and behavior. As an experienced consumer in the English-speaking world, you have almost certainly been the target of IMC activities. (Practically every time you "like" a TV show, article, or a meme on Facebook, you are participating in an IMC effort!)

What Is Marketing Communication?

Defining marketing communication is tricky because, in a real sense, everything an organization does has communication potential. The price placed on a product communicates something very specific about the product. A company that chooses to distribute its products strictly through discount stores sends a distinct message to the market. Marketing communication refers to activities deliberately focused on promoting an offering among target audiences. The following definition helps to clarify this term:

Marketing communication includes all the messages, media, and activities used by an organization to communicate with the market and help persuade target audiences to accept its messages and take action accordingly.

Integrated marketing communication is the the process of coordinating all this activity across different communication methods. Note that a central theme of this definition is persuasion: persuading people to believe something, to desire something, and/or to do something. Effective marketing communication is goal directed, and it is aligned with an organization's marketing strategy. It aims to deliver a particular message to a specific audience with a targeted purpose of altering perceptions and/or behavior. Integrated marketing communication (IMC) makes this marketing activity more efficient and effective because it relies on multiple communication methods and customer touch points to deliver a consistent message in more ways and in more compelling ways.

The Promotion Mix: Marketing Communication Methods

The ***promotion mix*** refers to how marketers combine a range of marketing communication methods to execute their marketing activities. Different methods of marketing communication have distinct advantages and complexities, and it requires skill and experience to deploy them effectively. Not surprisingly, marketing communication methods evolve over time as new communication tools and capabilities become available to marketers and the people they target.

Seven common methods of marketing communication are described below:

- **Advertising:** Any paid form of presenting ideas, goods, or services by an identified sponsor. Historically, advertising messages have been tailored to a group and employ mass media such as radio, television, newspaper, and magazines. Advertising may also target individuals according to their profile characteristics or behavior; examples are the weekly ads mailed by supermarkets to local residents or online banner ads targeted to individuals based on the sites they visit or their Internet search terms.
- **Public relations (PR):** The purpose of public relations is to create goodwill between an organization (or the things it promotes) and the "public" or target segments it is trying to reach. This happens through unpaid or earned promotional opportunities: articles, press and media coverage, winning awards, giving presentations at conferences and events, and otherwise getting favorable attention through vehicles not paid for by the sponsor. Although organizations earn rather than pay for the PR attention they receive, they may spend significant resources on the activities, events, and people who generate this attention.
- **Personal selling:** Personal selling uses people to develop relationships with target audiences for the purpose of selling products and services. Personal selling puts an emphasis on face-to-face interaction, understanding the customer's needs, and demonstrating how the product or service provides value.
- **Sales promotion:** Sales promotions are marketing activities that aim to temporarily boost sales of a product or service by adding to the basic value offered, such as "buy one get one free" offers to consumers or "buy twelve cases and get a 10 percent discount" to wholesalers, retailers, or distributors.
- **Direct marketing:** This method aims to sell products or services directly to consumers rather than going through retailer. Catalogs, telemarketing, mailed brochures, or promotional materials and television home shopping channels are all common traditional direct marketing tools. Email and mobile marketing are two next-generation direct marketing channels.
- **Digital marketing:** Digital marketing covers a lot of ground, from Web sites to search-engine, content, and social media marketing. Digital marketing tools and techniques evolve rapidly with technological advances, but this umbrella term covers all of the ways in which digital technologies are used to market and sell organizations, products, services, ideas, and experiences.
- **Guerrilla marketing:** This newer category of marketing communication involves unconventional, innovative, and usually low-cost marketing tactics to engage consumers in the marketing activity, generate attention and achieve maximum exposure for an organization, its products, and/or services. Generally guerrilla marketing is experiential: it creates a novel situation or memorable experience consumers connect to a product or brand.

Guerrilla marketing: a lamppost transformed into a McDonald's coffeepot. Source: http://janjan-design.blogspot.com/20...loving-it.html

Most marketing initiatives today incorporate multiple methods: hence the need for IMC. Each of these marketing communication methods will be discussed in further detail later in this module.

The Objectives of Marketing Communication

The basic objectives of all marketing communication methods are (1) to communicate, (2) to compete, and (3) to convince. In order to be effective, organizations should ensure that whatever information they communicate is clear, accurate, truthful, and useful to the stakeholders involved. In fact, being truthful and accurate in marketing communications is more than a matter of integrity; it's also a matter of legality, since fraudulent marketing communications can end in lawsuits and even the criminal justice system.

Marketing communication is key to competing effectively, particularly in markets where competitors sell essentially the same product at the same price in the same outlets. Only through marketing communications may an organization find ways to appeal to certain segments, differentiate its product, and create enduring brand loyalty. Remaining more appealing or convincing than competitors' messages is an ongoing challenge.

Ideally, marketing communication is convincing: it should present ideas, products, or services in such a compelling way that target segments are led to take a desired action. The ability to persuade and convince is essential to winning new business, but it may also be necessary to reconvince and retain many consumers and customers. Just because a customer buys a particular brand once or a dozen times, or even for a dozen years, there is no guarantee that the person will stick with the original product. That is why marketers want to make sure he or she is constantly reminded of the product's unique benefits.

Common Marketing Communication Methods

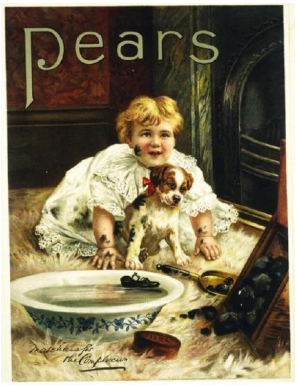
In a successfully operated campaign, all activities will be well coordinated to build on one another and increase the overall impact. For example, a single campaign might include:

- **Advertising:** A series of related, well-timed, carefully placed television ads coupled with print advertising in selected magazines and newspapers
- **Direct marketing:** Direct-to-consumer mail pieces sent to target segments in selected geographic areas, reinforcing the messages from the ads
- **Personal selling:** Preparation for customer sales representatives about the campaign to equip them to explain and demonstrate the product benefits stressed in advertising
- **Sales promotions:** In-store display materials reflecting the same messages and design as the ads, emphasizing point-of-sale impact
- **Digital marketing:** Promotional information on the organization's Web site that reflects the same messages, design, and offers reflected in the ads; ads themselves may be posted on the Website, YouTube, Facebook, and shared in other social media
- **Public relations:** A press release announcing something newsworthy in connection to the campaign focus, objectives, and target segment(s)

Advertising

Advertising is probably the first thing you think of when you think of marketing. Advertising is any paid form of communication from an identified sponsor or source that draws attention to ideas, goods, services or the sponsor itself: essentially commercials and ads (whether digital or print). Most advertising is directed toward groups rather than individuals, and advertising is usually delivered through media such as television, radio, newspapers and, increasingly, the internet. Ads are often measured in *impressions* (the number of times a consumer is exposed to an advertisement).

Advantages and Disadvantages of Advertising



As a method of marketing communication, advertising has both advantages and disadvantages. In terms of advantages, advertising creates a sense of credibility or legitimacy when an organization invests in presenting itself and its products in a public forum. Ads can convey a sense of quality and permanence, the idea that a company isn't some fly-by-night venture. Advertising allows marketers to repeat a message at intervals selected strategically. Repetition makes it more likely that the target audience will see and recall a message, which improves awareness-building results. Advertising can generate drama and human interest by featuring people and situations that are exciting or engaging. Finally, advertising is an excellent vehicle for brand building, as it can create rational and emotional connections with a company or offering that translate into goodwill.

The primary disadvantage of advertising is cost. Marketers question whether this communication method is really cost-effective at reaching large groups. Of course, costs vary depending on the medium, with television ads being very expensive to produce and place. In contrast, print and digital ads tend to be much less expensive. Along with cost is the question of how many people an advertisement actually reaches. Ads are easily tuned out in today's crowded media marketplace. Even ads that initially grab attention can grow stale over time. Because

advertising is a one-way medium, there is usually little direct opportunity for consumer feedback and interaction, particularly from consumers who often feel overwhelmed by competing market messages.

Direct Marketing

Direct marketing activities bypass any intermediaries and communicate directly with the individual consumer. Direct mail is personalized to the individual consumer, based on whatever a company knows about that person's needs, interests, behaviors, and preferences. Traditional direct marketing activities include mail, catalogs, and telemarketing. The thousands of "junk mail" offers from credit card companies, bankers, and charitable organizations that flood mailboxes every year are artifacts of direct marketing. Telemarketing contacts prospective customers via the telephone to pitch offers and collect information. Today, direct marketing overlaps heavily with digital marketing, as marketers rely on email and, increasingly, mobile communications to reach and interact with consumers.

If you've ever paid off an auto loan, you may have noticed a torrent of mail offers from car dealerships right around the five-year mark. They know, from your credit history, that you're nearly done paying off your car and you've had the vehicle for several years, so you might be interested in trading up for a newer model. Based on your geography and any voter registration information, you may be targeted during election season to participate via telephone in political polls and to receive "robocalls" from candidates and parties stomping for your vote. Moving into the digital world, virtually any time you share an email address with an organization, it becomes part of a database to be used for future marketing.

Advantages and Disadvantages of Direct Marketing

Direct marketing can offer significant value to consumers by tailoring their experience in the market to things that most align with their needs and interests. If you're going to have a baby (and you don't mind people knowing about it), wouldn't you rather have Target send you special offers on baby products than on men's shoes or home improvement goods? Additionally, direct marketing can be a powerful tool for anticipating and predicting customer needs and behaviors. Over time, as companies use consumer data to understand their target audiences and market dynamics, they can develop more effective campaigns and offers.

Among the leading disadvantages of direct marketing are, not surprisingly, customer concerns about privacy and information security. Data-driven direct marketing might seem a little creepy or even nefarious, and certainly it can be when marketers are insensitive or unethical in their use of consumer data. Direct marketing also takes place in a crowded, saturated market in which people are only too willing to toss junk mail and unsolicited email into trash bins without a second glance. Electronic spam filters screen out many email messages, so people may never even see email messages from many of the organizations that send them.

Heavy reliance on data also leads to the challenge of keeping databases and contact information up to date and complete, a perennial problem for many organizations. Finally, direct marketing implies a direct-to-customer business model that inevitably requires companies to provide an acceptable level of customer service and interaction to win new customers and retain their business.

Personal Selling

Personal selling uses in-person interaction to sell products and services. This type of communication is carried out by sales representatives, who are the personal connection between a buyer and a company or a company's products or services. In addition to enhancing customer relationships, this type of marketing communications tool can be a powerful source of customer feedback, as well.

Effective personal selling addresses the buyer's needs and preferences without making him or her feel pressured. Good salespeople offer advice, information, and recommendations, and they can help buyers save money and time during the decision process. The seller should give honest responses to any questions or objections the buyer has and show that the company cares more about meeting the buyer's needs than making the sale. Attending to these aspects of personal selling contributes to a strong, trusting relationship between buyer and seller.[1]

Advantages and Disadvantages of Personal Selling

The most significant strength of personal selling is its flexibility. Salespeople can tailor their presentations to fit the needs, motives, and behavior of individual customers. A salesperson can gauge the customer's reaction to a sales approach and immediately adjust

the message to facilitate better understanding. A salesperson is also in an excellent position to encourage the customer to act. The one-on-one interaction of personal selling means that a salesperson can effectively respond to and overcome objections—e.g., concerns or reservations about the product—so that the customer is more likely to buy. Salespeople can also offer many customized reasons that might spur a customer to buy, whereas an advertisement offers a limited set of reasons that may not persuade everyone in the target audience.

Personal selling also minimizes wasted effort. Advertisers can spend a lot of time and money on a mass-marketing message that reaches many people outside the target market (but doesn't result in additional sales). In personal selling, the sales force pinpoints the target market, makes a contact, and focuses effort that has a strong probability of leading to a sale.

High cost is the primary disadvantage of personal selling. With increased competition, higher travel and lodging costs, and higher salaries, the cost per sales contract continues to rise. Many companies try to control sales costs by compensating sales representatives through commissions or by using complementary techniques, such as telemarketing, direct mail, toll-free numbers for interested customers, and online communication with qualified prospects. Another weakness of personal selling is message inconsistency. Many salespeople view themselves as independent from the organization, so they design their own sales techniques, use their own message strategies, and engage in questionable ploys to generate sales. (You'll recall our discussion in the ethics module about the unique challenges that B2B salespeople face.) As a result, it can be difficult to find a unified company or product message within a sales force or between the sales force and the rest of the marketing mix.

Sales Promotions

Sales promotions are a marketing communication tool for stimulating revenue or providing incentives or extra value to distributers, sales staff, or customers over a short time period. Sales promotion activities include special offers, displays, demonstrations, and other nonrecurring selling efforts that aren't part of the ordinary routine. As an additional incentive to buy, these tools can be directed at consumers, retailers and other distribution partners, or the manufacturer's own sales force.

Companies use many different forms of media to communicate about sales promotions, such as printed materials like posters, coupons, direct mail pieces and billboards; radio and television ads; digital media like text messages, email, websites and social media, and so forth.

Most consumers are familiar with common sales promotion techniques including samples, coupons, point-of-purchase displays, premiums, contents, loyalty programs, and rebates.

Advantages and Disadvantages of Sales Promotions[2]

In addition to their primary purpose of boosting sales in the near term, companies can use consumer sales promotions to help them understand price sensitivity. Coupons and rebates provide useful information about how pricing influences consumers' buying behavior. Sales promotions can also be a valuable–and sometimes sneaky–way to acquire contact information for current and prospective customers. Many of these offers require consumers to provide their names and other information in order to participate. Electronically-scanned coupons can be linked to other purchasing data, to inform organizations about buying habits. All this information can be used for future marketing research, campaigns and outreach.

Consumer sales promotions can generate loyalty and enthusiasm for a brand, product, or service. Frequent flyer programs, for example, motivate travelers to fly on a preferred airline even if the ticket prices are somewhat higher. If sales have slowed, a promotion such as a sweepstakes or contest can spur customer excitement and (re)new interest in the company's offering. Sales promotions are a good way of energizing and inspiring customer action.

Trade promotions offer distribution channel partners financial incentives that encourage them to support and promote a company's products. Offering incentives like prime shelf space at a retailer's store in exchange for discounts on products has the potential to build and enhance business relationships with important distributors or businesses. Improving these relationships can lead to higher sales, stocking of other product lines, preferred business terms and other benefits.

Sales promotions can be a two-edged sword: if a company is continually handing out product samples and coupons, it can risk tarnishing the company's brand. Offering too many freebies can signal to customers that they are not purchasing a prestigious or "limited" product. Another risk with too-frequent promotions is that savvy customers will hold off purchasing until the next promotion, thus depressing sales.

Often businesses rush to grow quickly by offering sales promotions, only to see these promotions fail to reach their sales goals and target customers. The temporary boost in short term sales may be attributed to highly price-sensitive consumers looking for a deal, rather than the long-term loyal customers a company wants to cultivate. Sales promotions need to be thought through, designed and

promoted carefully. They also need to align well with the company's larger business strategy. Failure to do so can be costly in terms of dollars, profitability and reputation.

If businesses become overly reliant on sales growth through promotions, they can get trapped in short-term marketing thinking and forget to focus on long-term goals. If, after each sales dip, a business offers another sales promotion, it can be damaging to the long-term value of its brand.

Digital Marketing

Digital marketing is an umbrella term for using a digital tools to promote and market products, services, organizations and brands. As consumers and businesses become more reliant on digital communications, the power and importance of digital marketing have increased. There are several essential tools in the digital marketing tool kit: email, mobile marketing, websites, content marketing and search-engine optimization (SEO), and social media marketing. For now, we'll focus on websites and social media.

Websites represent an all-in-one storefront, a display counter, and a megaphone for organizations to communicate in the digital world. For digital and bricks-and-mortar businesses, websites are a primary channel for communicating with current and prospective customers as well as other audiences. A good website provides evidence that an organization is real, credible, and legitimate.

Social media are distinctive for their networking capabilities: they allow people to reach and interact with one another through interconnected networks. This "social" phenomenon changes the power dynamic in marketing: no longer is the marketer the central gatekeeper for all communication about a product, service, brand, or organization. Social media allows for organic dialogue and activity to happen directly between individuals, unmediated by a company. Companies can (and should) listen, learn, and find ways to participate authentically.

Advantages and Disadvantages of Digital Marketing

Websites have so many advantages that there is almost no excuse for a business not to have one. Effective website marketing declares to the world that an organization exists, what value it offers, and how to do business. Websites can be an engine for generating customer data and new business leads. An electronic storefront is often dramatically less expensive than a physical storefront, and it can serve customers virtually anywhere in the world with internet access. Websites are very flexible and easy to alter. Organizations can try out new strategies, content and tactics at relatively low cost to see what works and where the changes pay off.

The advantages and benefits of social media marketing focus heavily on the two-way and even multidirectional communication between customers, prospects, and advocates for your company or brand. By listening and engaging in social media, organizations are better equipped to understand and respond to market sentiment. Social media helps organizations identify and cultivate advocates for its products, services, and brand, including the emergence of customers who can become highly credible, trusted voices to help you sell.

At the same time, digital marketing strategies carry costs and risks. Websites require some investment of time and money to set up and maintain. Organizations should make wise, well-researched decisions about information infrastructure and website hosting, to ensure their sites remain operational with good performance and uptime. Companies that capture and maintain customer data through their websites must be vigilant about information security to prevent hackers from stealing sensitive customer data.

Social media also carry a number of inherent challenges. Social media are dynamic environments that requires significant effort to monitor and stay current on. It is also difficult to continually create "share-worthy" content. The variety of social media tools makes it a challenge to understand which platforms to use for which target audiences and calls to action. Crisis communications can be difficult, too, particularly in the public environment of social media, in which it is difficult to contain or control communication. This means it can be difficult to mitigate the impact of a crisis on the brand. One of the biggest challenges facing organizations is determining who in the organization should "own" the social media platforms for the organization. Too few hands to help means the burden of content creation is high on a single individual. However, too many people often results in duplication of efforts or conflicting content.

Public Relations

Public relations (PR) is the process of maintaining a favorable image and building beneficial relationships between an organization and the public communities, groups, and people it serves. Unlike advertising, which tries to create favorable impressions through paid messages, public relations does not pay for attention and publicity. Instead, PR strives to earn a favorable image by drawing

attention to newsworthy and attention-worthy activities of the organization and its customers. For this reason, PR is often referred to as “free advertising.”

In fact, PR is not a costless form of promotion. It requires salaries to be paid to people who oversee and execute PR strategy. It also involves expenses associated with events, sponsorships and other PR-related activities.

The following video, about Tyson Foods’ “Meals That Matter” program, shows how one company cooked up an idea that is equal parts public relations and corporate social responsibility (CSR). The video covers the Tyson disaster-relief team delivering food to the residents of Moore, Oklahoma, shortly after tornados struck the area on May 20, 2013. The company received favorable publicity following the inauguration of the program in 2012. (You can read one of the articles here: “Tyson Foods Unveils Disaster Relief Mobile Feeding Unit.”)

Advantages and Disadvantages of Public Relations

Because PR activity is earned rather than paid, it tends to carry more credibility and weight. For example, when a news story profiles a customer’s successful experience with a company and its products, people tend to view this type of article as less biased (and therefore more credible) than a paid advertisement. The news story comes from an objective reporter who feels the story is worth telling. Meanwhile an advertisement on a similar topic would be viewed with skepticism because it is a paid placement from a biased source: the ad sponsor.

Using IMC to Support Marketing Strategies

Determining which marketing communication methods and tools to use and how best to combine them is a challenge for any marketer planning a promotional strategy. To aid the planning process, marketing managers often use a campaign approach. A *campaign* is a planned, coordinated series of marketing communication efforts built around a single theme or idea and designed to reach a particular goal. For years, the term “campaign” has been used in connection with advertising, and this term applies equally well to the entire IMC program.

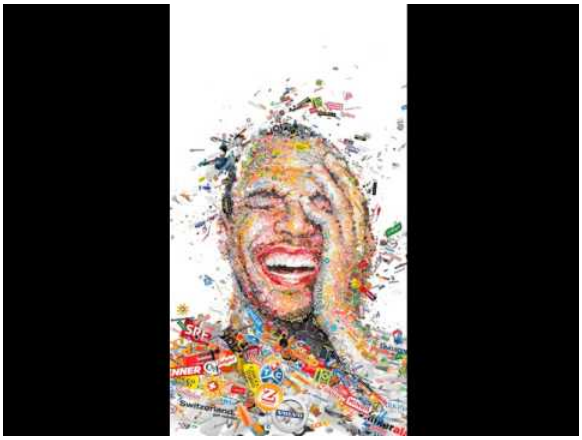
Organizations may conduct many types of IMC campaigns, and several may be run concurrently. Geographically, a firm may have a local, regional, or national campaign, depending upon the available funds, objectives, and market scope. One campaign may be aimed at consumers and another at wholesalers and retailers. Different marketing campaigns might target different segments simultaneously, delivering

messages and using communication tools tailored to each segment. Marketers use a marketing plan (sometimes called an IMC plan) to track and execute a set of campaigns over a given period of time.

A campaign revolves around a theme, a central idea, focal point, or purpose. This theme permeates all IMC efforts and works to unify the campaign. The theme may refer to the campaign's goals—for example, KCRW "Capital Campaign" launched by the popular Los Angeles-based public radio station KCRW to raise $48 million to build a new state-of-the-art media facility for its operations. The theme may also refer to the shift in customer attitudes or behavior that a campaign focuses on—such as new-member campaigns launched by numerous member organizations, from professional associations to school parent-teacher organizations. A theme might take the form of a slogan, such as Coca-Cola's "Taste the Feeling" campaign or DeBeers' "A diamond is forever."

Clear Channel is a marketing company that specializes in outdoor advertising. For their latest advertising campaign in Switzerland, they created a slogan-based theme, "Where Brands Meet People," and asked their clients to participate in dramatizing it. Dozens of Swiss companies gave their logo to be used as individual "tiles" in three colorful mosaic portraits.[3] These mosaics, two of which are below, appeared on the Web and on the streets of Switzerland. Click here if you want to see a higher-resolution version that reveals all the brands that make up the mosaics.

Some of the billboards appeared in animated form, as below:



Marketing campaigns may also adopt themes that refer to a stage in the product life cycle, such as McDonald's 2015 "All-Day Breakfast" rollout campaign. Some organizations use the same theme for several campaigns; others develop a different theme for each new campaign.

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1. http://smallbusiness.chron.com/strat...ues-15747.html ↵
2. http://edwardlowe.org/digital-librar...omotional-mix/ ↵
3. www.behance.net/gallery/2987...ds-meet-people ↵

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14.4: Place

What you'll learn to do: explain common product distribution strategies and how organizations use them

Distribution channels—which is "place" in the four Ps—cover all the activities needed to transfer the ownership of goods and move them from the point of production to the point of consumption. In this section you'll learn more about distribution channels and some of the common strategies companies use to take advantage of them.

Learning Objectives

- Describe the channel partners that support distribution channels
- Describe the different types of retailers businesses use to distribute products
- Differentiate between supply chains and distributions channels

Channels of Distribution

Evolution of Channels of Distribution

As consumers, we take for granted that when we go to a supermarket the shelves will be filled with the products we want; when we are thirsty there will be a Coke machine or bar around the corner, and we count on being able to get online and find any product available for purchase and quick delivery. Of course, if we give it some thought, we realize that this magic is not a given and that hundreds of thousands of people plan, organize, and labor long hours to make this convenience available. It has not always been this way, and it is still not this way in many other parts of the world.

Looking back over time, the channel structure in primitive culture was virtually nonexistent. The family or tribal group was almost entirely self-sufficient. The group was composed of individuals who were both communal producers and consumers of whatever goods and services could be made available. As economies evolved, people began to specialize in some aspect of economic activity. They engaged in farming, hunting, or fishing, or some other basic craft. Eventually this specialized skill produced excess products, which they exchanged or traded for needed goods that had been produced by others. This exchange process or barter marked the beginning of formal channels of distribution. These early channels involved a series of exchanges between two parties who were producers of one product and consumers of the other.

With the growth of specialization, particularly industrial specialization, and with improvements in methods of transportation and communication, channels of distribution have become longer and more complex. Thus, corn grown in Illinois may be processed into corn chips in West Texas, which are then distributed throughout the United States. Or, turkeys raised in Virginia are sent to New York so that they can be shipped to supermarkets in Virginia. Channels do not always make sense.

The channel mechanism also operates for service products. In the case of medical care, the channel mechanism may consist of a local physician, specialists, hospitals, ambulances, laboratories, insurance companies, physical therapists, home care professionals, and so on. All of these individuals are interdependent and could not operate successfully without the cooperation and capabilities of all the others.

Based on this relationship, we define a ***channel of distribution***, also called a marketing channel, as sets of interdependent organizations involved in the process of making a product or service available for use or consumption, as well as providing a payment mechanism for the provider.

This definition implies several important characteristics of the channel.

First, the channel consists of *organizations*, some under the control of the producer and some outside the producer's control. Yet all must be recognized, selected, and integrated into an efficient channel arrangement.

Second, the channel management process is continuous and requires continuous monitoring and reappraisal. The channel operates twenty-four hours a day and exists in an environment where change is the norm.

Finally, channels should have certain distribution objectives guiding their activities. The structure and management of the marketing channel is thus, in part, a function of a firm's distribution objective. It's also a part of the marketing objectives, especially the need to make an acceptable profit. Channels usually represent the largest costs in marketing a product.

Channel Flows

One traditional framework that has been used to express the channel mechanism is the concept of flow. These flows reflect the many linkages that tie channel members and other agencies together in the distribution of goods and services. From the perspective of the channel manager, there are five important flows.

1. **Product flow:** the movement of the physical product from the manufacturer through all the parties who take physical possession of the product until it reaches the ultimate consumer
2. **Negotiation flow:** the institutions that are associated with the actual exchange processes
3. **Ownership flow:** the movement of title through the channel
4. **Information flow:** the individuals who participate in the flow of information either up or down the channel
5. **Promotion flow:** the flow of persuasive communication in the form of advertising, personal selling, sales promotion, and public relations

monster channel flow

The figure below maps the channel flows for the Monster Energy drink (and many other energy drink brands). Why is Monster's relationship with Coca-Cola so valuable? Every single flow passes through bottlers and distributors in order to arrive in supermarkets where the product will be available to consumers.

Coca-Cola explains the importance of the bottlers in the distribution network:

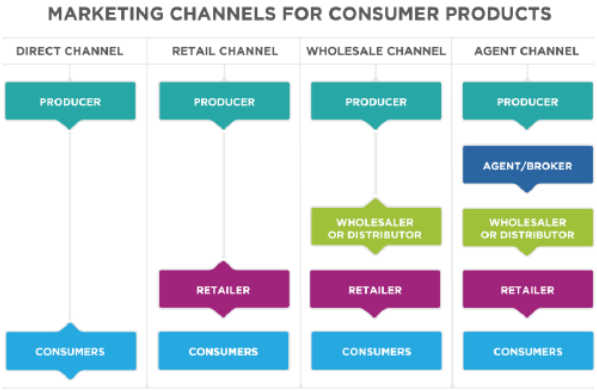
> "While many view our Company as simply "Coca-Cola," our system operates through multiple local channels. Our Company manufactures and sells concentrates, beverage bases and syrups to bottling operations, owns the brands and is responsible for consumer brand marketing initiatives. Our bottling partners manufacture, package, merchandise and distribute the final branded beverages to our customers and vending partners, who then sell our products to consumers.
>
> *All bottling partners work closely with customers — grocery stores, restaurants, street vendors, convenience stores, movie theaters and amusement parks, among many others — to execute localized strategies developed in partnership with our Company. Customers then sell our products to consumers at a rate of more than 1.9 billion servings a day.*[1]"

Revisiting the channel flows we find that the bottlers and distributors play a role in each flow. Examples of the flows are listed below. Remember, while the consumer is the individual who eventually consumes the drink, the supermarkets, restaurants, and other outlets are Coca-Cola's customers.

- Negotiation flow: the bottlers buy concentrate, sell product and collect revenue from customers
- Information flow: bottlers communicate product options to customers and communicate demand and needs to Coca-Cola
- Promotion flow: bottlers communicate benefits and provide promotional materials to customers

Channel Partners

While channels can be very complex, there is a common set of channel structures that can be identified in most transactions. Each channel structure includes different organizations. Generally, the organizations that collectively support the distribution channel are referred to as **channel partners**.



The **direct channel** is the simplest channel. In this case, the producer sells directly to the consumer. The most straightforward examples are producers who sell in small quantities. If you visit a farmer's market, you can purchase goods directly from the farmer or craftsman. There are also examples of very large corporations who use the direct channel effectively, especially for B2B transactions. Services may also be sold through direct channels, and the same principle applies: an individual buys a service directly from the provider who delivers the service.

Examples of the direct channel include:

- Etsy.com online marketplace
- Farmer's markets
- Oracle's personal sales team that sells software systems to businesses
- A bake sale

Retailers are companies in the channel that focuses on selling directly to consumers. You are likely to participate in the **retail channel** almost every day. The retail channel is different from the direct channel in that the retailer doesn't produce the product. The retailer markets and sells the goods on behalf of the producer. For consumers, retailers provide tremendous contact efficiency by creating one location where many products can be purchased. Retailers may sell products in a store, online, in a kiosk, or on your doorstep. The emphasis is not the specific location but on selling directly to the consumer.

Examples of retailers include:

- Walmart discount stores
- Amazon online store
- Nordstrom department store
- Dairy Queen restaurant

From a consumer's perspective, the **wholesale channel** looks very similar to the retail channel, but it also involves a wholesaler. A wholesaler is primarily engaged in buying and usually storing and physically handling goods in large quantities, which are then resold (usually in smaller quantities) to retailers or to industrial or business users. The vast majority of goods produced in an

advanced economy have wholesaling involved in their distribution. Wholesale channels also include manufacturers who operate sales offices to perform wholesale functions, and retailers who operate warehouses or otherwise engage in wholesale activities.

Examples of wholesalers include:

- Christmas-tree wholesalers who buy from growers and sell to retail outlets
- Restaurant food suppliers
- Clothing wholesalers who sell to retailers

The broker or **agent channel** includes one additional intermediary. Agents and brokers are different from wholesalers in that they *do not take title* to the merchandise. In other words, they do not own the merchandise because they neither buy nor sell. Instead, brokers bring buyers and sellers together and negotiate the terms of the transaction: agents represent either the buyer or seller, usually on a permanent basis; brokers bring parties together on a temporary basis. Think about a real-estate agent. They do not buy your home and sell it to someone else; they market and arrange the sale of the home. Agents and brokers match up buyers and sellers, or add expertise to create a more efficient channel.

Examples of brokers include:

- An insurance broker, who sells insurance products from many companies to businesses and individuals
- A literary agent, who represents writers and their written works to publishers, theatrical producers, and film producers
- An export broker, who negotiates and manages transportation requirements, shipping, and customs clearance on behalf of a purchaser or producer

It's important to note that the larger and more complex the flow of materials from the initial design through purchase, the more likely it is that multiple channel partners may be involved, because each channel partner will bring unique expertise that increases the efficiency of the process. If an intermediary is not adding value, they will likely be removed over time, because the cost of managing and coordinating with each intermediary is significant.

The Role of Wholesale Intermediaries

While we are probably most familiar with the retail channel, wholesalers play an important role as intermediaries. Intermediaries act as a link in the distribution process, but the roles they fill are broader than simply connecting the different channel partners. Wholesalers, often called "merchant wholesalers," help move goods between producers and retailers.

For example, McLane Company Inc. is among the largest wholesalers in the United States. The breadth of its operations is described on the company Web site:

> *"McLane Foodservice and wholly owned subsidiary, Meadowbrook Meat Company, Inc., operates 80 distribution centers across the U.S. and one of the nation's largest private fleets. The company buys, sells, and delivers more than 50,000 different consumer products to nearly 90,000 locations across the U.S. In addition, McLane provides alcoholic beverage distribution through its wholly owned subsidiary, Empire Distributors, Inc. McLane is a wholly owned unit of Berkshire Hathaway Inc. and employs more than 20,000 teammates.[2]"*

Let's look at each of the functions that a merchant wholesaler fulfills.

Purchasing

Wholesalers purchase very large quantities of goods directly from producers or from other wholesalers. By purchasing large quantities or volumes, wholesalers are able to secure significantly lower prices.

Imagine a situation in which a farmer grows a very large crop of potatoes. If he sells all of the potatoes to a single wholesaler, he will negotiate one price and make one sale. Because this is an efficient process that allows him to focus on farming (rather than

searching for additional buyers), he will likely be willing to negotiate a lower price. Even more important, because the wholesaler has such strong buying power, the wholesaler is able to force a lower price on every farmer who is selling potatoes.

The same is true for almost all mass-produced goods. When a producer creates a large quantity of goods, it is most efficient to sell all of them to one wholesaler, rather than negotiating prices and making sales with many retailers or an even larger number of consumers. Also, the bigger the wholesaler is, the more likely it will have significant power to set attractive prices.

Warehousing and Transportation

Once the wholesaler has purchased a mass quantity of goods, it needs to get them to a place where they can be purchased by consumers. This is a complex and expensive process. McLane Company operates eighty distribution centers around the country. Its distribution center in Northfield, Missouri, is 560,000 square feet big and is outfitted with a state-of-the art inventory tracking system that allows it to manage the diverse products that move through the center.[3] It relies on its own vast trucking fleet to handle the transportation.

Grading and Packaging

Wholesalers buy a very large quantity of goods and then break that quantity down into smaller lots. The process of breaking large quantities into smaller lots that will be resold is called bulk breaking. Often this includes physically sorting, grading, and assembling the goods. Returning to our potato example, the wholesaler would determine which potatoes are of a size and quality to sell individually and which are to be packaged for sale in five-pound bags.[4]

Risk Bearing

Wholesalers either take title to the goods they purchase, or they own the goods they purchase. There are two primary consequences of this, both of which are both very important to the distribution channel. First, it means that the wholesaler finances the purchase of the goods and carries the cost of the goods in inventory until they are sold. Because this is a tremendous expense, it drives wholesalers to be accurate and efficient in their purchasing, warehousing, and transportation processes.

Second, wholesalers also bear the risk for the products until they are delivered. If goods are damaged in transport and cannot be sold, then the wholesaler is left with the goods and the cost. If there is a significant change in the value of the products between the time of the purchase from the producer and the sale to the retailer, the wholesaler will absorb that profit or loss.

Marketing

Often, the wholesaler will fill a role in the promotion of the products that it distributes. This might include creating displays for the wholesaler's products and providing the display to retailers to increase sales. The wholesaler may advertise its products that are carried by many retailers.

Wholesalers also influence which products the retailer offers. For example, McLane Company was a winner of the 2016 Convenience Store News Category Captains, in recognition for its innovations in providing the right products to its customers. McLane created unique packaging and products featuring movie themes, college football themes, and other special occasion branding that were designed to appeal to impulse buyers. They also shifted the transportation and delivery strategy to get the right products in front of consumers at the time they were most likely to buy. Its convenience store customers are seeing sales growth, as is the wholesaler.[5]

Distribution

As distribution channels have evolved, some retailers, such as Walmart and Target, have grown so large that they have taken over aspects of the wholesale function. Still, it is unlikely that wholesalers will ever go away. Most retailers rely on wholesalers to fulfill the functions that we have discussed, and they simply do not have the capability or expertise to manage the full distribution process. Plus, many of the functions that wholesalers fill are performed most efficiently at scale. Wholesalers are able to focus on creating efficiencies for their retail channel partners that are very difficult to replicate on a small scale.

Retailers that Distribute Products

Retailing involves all activities required to market consumer goods and services to ultimate consumers who are purchasing for individual or family needs.

By definition, B2B purchases are not included in the retail channel since they are not made for individual or family needs. In practice this can be confusing because many retail outlets do serve both consumers and business customers—like Home Depot, which has a Pro Xtra program for selling directly to builders and contractors. Generally, retailers that have a significant B2B or

wholesale business report those numbers separately in their financial statements, acknowledging that they are separate lines of business within the same company. Those with a pure retail emphasis do not seek to exclude business purchasers. They simply focus their offering to appeal to individual consumers, knowing that some businesses may also choose to purchase from them.

We typically think of a store when we think of a retail sale, even though retail sales occur in other places and settings. For instance, they can be made by a Pampered Chef salesperson in someone's home. Retail sales also happen online, through catalogs, by automatic vending machines, and in hotels and restaurants. Nonetheless, despite tremendous growth in both nontraditional retail outlets and online sales, most retail sales still take place in brick-and-mortar stores.

Beyond the distinctions in the products they provide, there are structural differences among retailers that influence their strategies and results. One of the reasons the retail industry is so large and powerful is its diversity. For example, stores vary in size, in the kinds of services that are provided, in the assortment of merchandise they carry, and in their ownership and management structures.

Department Stores

Department stores are characterized by their very wide product mixes. That is, they carry many different types of merchandise, which may include hardware, clothing, and appliances. Each type of merchandise is typically displayed in a different section or department within the store. The depth of the product mix depends on the store, but department stores' primary distinction is the ability to provide a wide range of products within a single store. For example, people shopping at Macy's can buy clothing for a woman, a man, and children, as well as house wares such as dishes and luggage.

Chain Stores

The 1920s saw the evolution of the chain store movement. Because chains were so large, they were able to buy a wide variety of merchandise in large quantity discounts. The discounts substantially lowered their cost compared to costs of single unit retailers. As a result, they could set retail prices that were lower than those of their small competitors and thereby increase their share of the market. Furthermore, chains were able to attract many customers because of their convenient locations, made possible by their financial resources and expertise in selecting locations.

Supermarkets

Supermarkets evolved in the 192os and 1930s. For example, Piggly Wiggly Food Stores, founded by Clarence Saunders around 1920, introduced self-service and customer checkout counters. Supermarkets are large, self-service stores with central checkout facilities. They carry an extensive line of food items and often nonfood products. There are 37,459 supermarkets operating in the United States, and the average store now carries nearly 44,000 products in roughly 46,500 square feet of space. The average customer visits a store just under twice a week, spending just over $30 per trip. Supermarkets' entire approach to the distribution of food and household cleaning and maintenance products is to offer large assortments these goods at each store at a minimal price.

Discount Retailers

Discount retailers, like Ross Dress for Less and Grocery Outlet, are characterized by a focus on price as their main sales appeal. Merchandise assortments are generally broad and include both hard and soft goods, but assortments are typically limited to the most popular items, colors, and sizes. Traditional stores are usually large, self-service operations with long hours, free parking, and relatively simple fixtures. Online retailers such as Overstock.com have aggregated products and offered them at deep discounts. Generally, customers sacrifice having a reliable assortment of products to receive deep discounts on the available products.

Warehouse Retailers

Warehouse retailers provide a bare-bones shopping experience at very low prices. Costco is the dominant warehouse retailer, with $79.7 billion in sales in 2014. Warehouse retailers streamline all operational aspects of their business and pass on the efficiency savings to customers. Costco generally uses a cost-plus pricing structure and provides goods in wholesale quantities.

Franchises

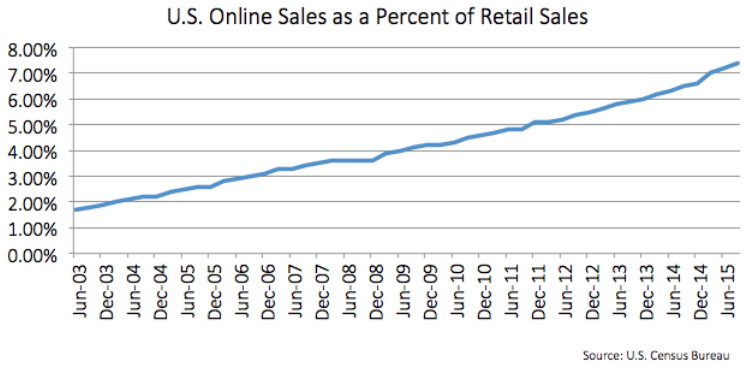
The franchise approach brings together national chains and local ownership. An owner purchases a franchise which gives her the right to use the firm's business model and brand for a set period of time. Often, the franchise agreement includes well-defined guidance for the owner, training, and on-going support. The owner, or franchisee, builds and manages the local business. *Entrepreneur* magazine posts a list each year of the 500 top franchises according to an evaluation of financial strength and stability, growth rate, and size. The 2016 list is led by Jimmy John's gourmet sandwiches, Hampton by Hilton midprice hotels, Supercuts hair salon, Servpro insurance/disaster restoration and cleaning, and Subway restaurants.

Malls and Shopping Centers

Malls and shopping centers are successful because they provide customers with a wide assortment of products across many stores. If you want to buy a suit or a dress, a mall provides many alternatives in one location. *Malls* are larger centers that typically have one or more department stores as major tenants. *Strip malls* are a common string of stores along major traffic routes, while isolated locations are freestanding sites not necessarily in heavy traffic areas. Stores in isolated locations must use promotion or some other aspect of their marketing mix to attract shoppers.

Online Retailing

Online retailing is unquestionably a dominant force in the retail industry, but today it accounts for only a small percentage of total retail sales. Companies like Amazon and Geico complete all or most of their sales online. Many other online sales result from online sales from traditional retailers, such as purchases made at Nordstrom.com. Online marketing plays a significant role in preparing the buyers who shop in stores. In a similar integrated approach, catalogs that are mailed to customers' homes drive online orders. In a survey on its Web site, Land's End found that 75 percent of customers who were making purchases had reviewed the catalog first.[6]



Catalog Retailing

Catalogs have long been used as a marketing device to drive phone and in-store sales. As online retailing began to grow, it had a significant impact on catalog sales. Many retailers who depended on catalog sales—Sears, Land's End, and J.C. Penney, to name a few—suffered as online retailers and online sales from traditional retailers pulled convenience shoppers away from catalog sales. Catalog mailings peaked in 2009 and saw a significant decrease through 2012. In 2013, there was a small increase in catalog mailings. Industry experts note that catalogs are changing, as is their role in the retail marketing process. Despite significant declines, U.S. households still receive 11.9 billion catalogs each year.[7]

Nonstore Retailing

Beyond those mentioned in the categories above, there's a wide range of traditional and innovative retailing approaches. Although the Avon lady largely disappeared at the end of the last century, there are still in-home sales from Arbonne facial products, cabi women's clothing, WineShop at Home, and others. Many of these models are based on the idea of a woman using her personal network to sell products to her friends and their friends, often in a party setting.

Vending machines and point-of-sale kiosks have long been a popular retail device. Today they are becoming more targeted, such as companies selling easily forgotten items—such as small electronics devices and makeup items—to travelers in airports.

Each of these retailing approaches can be customized to meet the needs of the target buyer or combined to span a range of needs.

Supply Chains and Distribution Channels

What Is a Supply Chain?

We have discussed the channel partners, the roles they fill, and the structures they create. Marketers have long recognized the importance of managing distribution channel partners. As channels have become more complex and the flow of business has become more global, organizations have recognized that they need to manage more than just the channel partners. They need to manage the full chain of organizations and transactions from raw materials through final delivery to the customer—in other words, **the supply chain**.

The **supply chain** is a system of organizations, people, activities, information, and resources involved in moving a product or service from supplier to customer. Supply chain activities involve the transformation of natural resources, raw materials, and components into a finished product that is delivered to the end customer.[8]

The marketing channel generally focuses on how to increase value to the customer by having the right product in the right place at the right price at the moment the customer wants to buy. The emphasis is on the providing value to the customer, and the marketing objectives usually focus on what is needed to deliver that value.

Supply chain management takes a different approach. The Council of Supply Chain Management Professionals (CSCMP) defines supply chain management as follows:

> *"Supply chain management encompasses the planning and management of all activities involved in sourcing and procurement, conversion, and all logistics management activities. Importantly, it also includes coordination and collaboration with channel partners, which can be suppliers, intermediaries, third-party service providers, and customers.[9]"*

Supply Chain vs. Marketing Channels

The supply chain and marketing channels can be differentiated in the following ways:

1. **The supply chain is broader than marketing channels.** It begins with raw materials and delves deeply into production processes and inventory management. Marketing channels are focused on bringing together the partners who can most efficiently deliver the right marketing mix to the customer in order to maximize value. Marketing channels provide a more narrow focus within the supply chain.
2. **Marketing channels are purely customer facing.** Supply chain management seeks to optimize how products are supplied, which adds a number of financial and efficiency objectives that are more internally focused. Marketing channels emphasize a stronger market view of the customer expectations and competitive dynamics in the marketplace.

3. **Marketing channels are part of the marketing mix**. Supply chain professionals are specialists in the delivery of goods. Marketers view distribution as one element of the marketing mix, in conjunction with product, price, and promotion. Supply chain management is more likely to identify the most efficient delivery partner. A marketer is more likely to balance the merits of a channel partner against the value offered to the customer. For instance, it might make sense to keep a channel partner who is less efficient but provides important benefit in the promotional strategy.

Successful organizations develop effective, respectful partnerships between the marketing and supply chain teams. When the supply chain team understands the market dynamics and the points of flexibility in product and pricing, they are better able to optimize the distribution process. When marketing has the benefit of effective supply chain management—which is analyzing and optimizing distribution within and beyond the marketing channels—greater value is delivered to customers.

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14.5: Price

What you'll learn to do: explain common pricing strategies and how organizations use them

In this section you'll learn about some very specific, yet standard pricing strategies that organizations use to meet their objectives and address consumer perceptions of value.

learning objective

- Describe the objectives businesses hope to achieve with product pricing
- Explain the methods businesses use for discounts and allowances

Customer Value and Price

Founders Jennifer Carter Fleiss (left) and Jennifer Hyman (right) at Rent the Runway headquarters

Rent the Runway is a company that lets customers borrow expensive designer dresses for a short time at a low price—to wear on a special occasion, e.g.—and then send them back. A customer can rent a Theia gown that retails for $995 for four days for the price of $150. Or, she can rent a gown from Laundry by Shelli Segal that retails for $325 for the price of $100. The company offers a 20 percent discount to first-time buyers and offers a "free second size" option to ensure that customers get the right fit.

Do the customers get a bargain when they are able to wear a designer dress for a special occasion at 15 percent of the retail price? Does the retail price matter to customers in determining value, or are they only considering the style and price they will pay for the rental?

What does value really mean in the pricing equation?

The Customer's View of Price

Whether a customer is the ultimate user of the finished product or a business that purchases components of the finished product, the customer seeks to satisfy a need through the purchase of a particular product. The customer uses several criteria to decide how much she is willing to spend in order to satisfy that need. Her preference is to pay as little as possible.

PRICE-VALUE EQUATION

VALUE = PERCEIVED BENEFITS - PERCEIVED COSTS

In order to increase value, the business can either increase the perceived benefits or reduce the perceived costs. Both are important aspects of price. If you buy a Louis Vuitton bag for $600, in return for this high price you perceive that you are getting a beautifully designed, well-made bag that will last for decades—in other words, the value is high enough for you that it can offset the cost. On the other hand, when you buy a parking pass to park in a campus lot, you are buying the convenience of a parking place close to your classes. Both of these purchases provide value at some cost. The perceived benefits are directly related to the price-value equation; some of the possible benefits are status, convenience, the deal, brand, quality, choice, and so forth. Some of these benefits tend to go hand in hand. For instance, a Mercedes Benz E750 is a very high-status brand name, and buyers expect superb quality to be part of the value equation (which makes it worth the $100,000 price tag). In other cases, there are tradeoffs between benefits. Someone living in an isolated mountain community might prefer to pay a lot more for groceries at a local store than drive sixty miles to the nearest Safeway. That person is willing to sacrifice the benefit of choice for the benefit of greater convenience.

When we talk about increasing perceived benefits, we refer to this as increasing the "value added." Identifying and increasing the value-added elements of a product are an important marketing strategy. In our initial example, Rent the Runway is providing dresses for special occasions. The price for the dress is reduced because the customer must give it back, but there are many value-added elements that keep the price relatively high, such as the broad selection of current styles and the option of trying a second size at no additional cost. In a very competitive marketplace, the value-added elements become increasingly important, as marketers use them to differentiate the product from other similar offerings.

Perceived costs include the actual dollar amount printed on the product, plus a host of additional factors. If you learn that a gas station is selling gas for 25 cents less per gallon than your local station, will you automatically buy from the lower-priced gas station? That depends. You will consider a range of other issues. How far do you have to drive to get there? Is it an easy drive or a drive through traffic? Are there long lines that will increase the time it takes to fill your tank? Is the low-cost fuel the grade or brand that you prefer? Inconvenience, poor service, and limited choice are all possible perceived costs. Other common perceived costs are the risk of making a mistake, related costs, lost opportunity, and unexpected consequences, to name but a few.

Viewing price from the customer's point of view pays off in many ways. Most notably, it helps define value–the most important basis for creating a competitive advantage.

Pricing Objectives

Companies set the prices of their products in order to achieve specific objectives. Consider the following examples.

nike

In 2014 Nike initiated a new pricing strategy. The company determined from a market analysis that its customers appreciated the value that the brand provided, which meant that it could charge a higher price for its products. Nike began to raise its prices 4–5 percent a year. Footwear News reported on the impact of their strategy:

> "The ability to raise prices is a key long-term advantage in the branded apparel and footwear industry—we are particularly encouraged that Nike is able to drive pricing while most U.S. apparel names are calling for elevated promotional [and] markdown levels in the near-term," said UBS analyst Michael Binetti. Binetti said Nike's new strategy is an emerging competitive advantage.[1]"

Nike's understanding of customer value enabled it to raise prices and achieve company growth objectives, increasing U.S. athletic footwear sales by $168 million in one year.

southwest airlines

In 2015 the U.S. airline industry lost $12 billion in value in one day because of concerns about potential price wars. When Southwest Airlines announced that it was increasing its capacity by 1 percent, the CEO of American Airlines—the world's largest airline—responded that American would not lose customers to price competition and would match lower fares. Forbes magazine reported on the consequences:

> "This induced panic among investors, as they feared that this would trigger a price war among the airlines. The investors believe that competing on prices would undermine the airline's ability to charge profitable fares, pull down their profits, and push them back into the shackles of heavy losses. Thus, the worried investors sold off stocks of major airlines, wiping out nearly $12 billion of market value of the airline industry in a single trading day.[2]"

Common Pricing Objectives

Not surprising, product pricing has a big effect on company objectives. (You'll recall that objectives are essentially a company's business goals.) Pricing can be used strategically to adjust performance to meet revenue or profit objectives, as in the Nike example above. Or, as the airline-industry example shows, pricing can also have unintended or adverse effects on a company's objectives. Product pricing will impact each of the objectives below:

- Profit objective: For example, “Increase net profit in 2016 by 5 percent”
- Competitive objective: For example, “Capture 30 percent market share in the product category”
- Customer objective: For example, “Increase customer retention”

Of course, over the long run, no company can really say, “We don’t care about profits. We are pricing to beat competitors.” Nor can the company focus only on profits and ignore how it delivers customer value. For this reason, marketers talk about a company’s “orientation” in pricing. Orientation describes the relative importance of one factor compared to the others. All companies must consider customer value in pricing, but some have an orientation toward profit. We would call this profit-oriented pricing.

Profit-Oriented Pricing

Profit-oriented pricing places an emphasis on the finances of the product and business. A business’s profit is the money left after all costs are covered. In other words, profit = revenue – costs. In profit-oriented pricing, the price per product is set higher than the total cost of producing and selling each product to ensure that the company makes a profit on each sale.

The benefit of profit-oriented pricing is obvious: the company is guaranteed a profit on every sale. There are real risks to this strategy, though. If a competitor has lower costs, then it can easily undercut the pricing and steal market share. Even if a competitor does not have lower costs, it might choose a more aggressive pricing strategy to gain momentum in the market.

Also, customers don’t really care about the company’s costs. Price is a component of the value equation, but if the product fails to deliver value, it will be difficult to generate sales.

Finally, profit-oriented pricing is often a difficult strategy for marketers to succeed with, because it limits flexibility. If the price is too high, then the marketer has to adjust other aspects of the marketing mix to create more value. If the marketer invests in the other three Ps—by, say, making improvements to the product, increasing promotion, or adding distribution channels—that investment will probably require additional budget, which will further raise the price.

It’s fairly standard for retailers to use some profit-oriented pricing—applying a standard mark-up over wholesale prices for products, for instance—but that’s rarely their only strategy. Successful retailers will also adjust pricing for some or all products in order to increase the value they provide to customers.

Competitor-Oriented Pricing

Sometimes prices are set almost completely according to competitor prices. A company simply copies the competitor’s pricing strategy or seeks to use price as one of the features that differentiates the product. That could mean either pricing the product higher than competitive products, to indicate that the firm believes it to provide greater value, or lower than competitive products in order to be a low-price solution.

This is a fairly simple way to price, especially with products whose pricing information is easily collected and compared. Like profit-oriented pricing, it carries some risks, though. Competitor-oriented pricing doesn’t fully take into account the value of the product to the customer vis-à-vis the value of competitive products. As a result, the product might be priced too low for the value it provides, or too high.

As the airline example illustrates, competitor-oriented pricing can contribute to a difficult market dynamic. If players in a market compete exclusively on price, they will erode their profits and, over time, limit their ability to add value to products.

Customer-Oriented Pricing

Customer-oriented pricing is also referred to as value-oriented pricing. Given the centrality of the customer in a marketing orientation (and this marketing course!), it will come as no surprise that customer-oriented pricing is the recommended pricing approach because its focus is on providing value to the customer. Customer-oriented pricing looks at the full price-value equation (Figure 1, above; discussed earlier in the module in “Demonstrating Customer Value”) and establishes the price that balances the value. The company seeks to charge the highest price *that supports the value received* by the customer.

Customer-oriented pricing requires an analysis of the customer and the market. The company must understand the buyer persona, the value that the buyer is seeking, and the degree to which the product meets the customer need. The market analysis shows

competitive pricing but also pricing for substitutes.

In an attempt to bring the customer voice into pricing decisions, many companies conduct primary market research with target customers. Crafting questions to get at the value perceptions of the customer is difficult, though, so marketers often turn to something called the Van Westerndorp price-sensitivity meter. This method uses the following four questions to understand customer perceptions of pricing:

1. At what price would you consider the product to be so expensive that you would not consider buying it? (Too expensive)
2. At what price would you consider the product to be priced so low that you would feel the quality couldn't be very good? (Too cheap)
3. At what price would you consider the product starting to get expensive, such that it's not out of the question, but you would have to give some thought to buying it? (Expensive/High Side)
4. At what price would you consider the product to be a bargain—a great buy for the money? (Cheap/Good Value)

Each of these questions asks about the customer's perspective on the product value, with price as one component of the value equation.

Cost-Plus Pricing Method

Cost-Plus Pricing

Cost-plus pricing, sometimes called *gross margin pricing*, is perhaps the most widely used pricing method. The manager selects as a goal a particular gross margin that will produce a desirable profit level. Gross margin is the difference between how much the goods cost and the actual price for which it sells. This gross margin is designated by a percent of net sales. The percent chosen varies among types of merchandise. That means that one product may have a goal of 48 percent gross margin while another has a target of 33.5 percent or 2 percent.

A primary reason that the cost-plus method is attractive to marketers is that they don't have to forecast general business conditions or customer demand. If sales volume projections are reasonably accurate, profits will be on target. Consumers may also view this method as fair, since the price they pay is related to the cost of producing the item. Likewise, the marketer is sure that costs are covered.

A major disadvantage of cost-plus pricing is its inherent inflexibility. For example, department stores often find it hard to meet (and beat) competition from discount stores, catalog retailers, and furniture warehouses because of their commitment to cost-plus pricing. Another disadvantage is that it doesn't take into account consumers' perceptions of a product's value. Finally, a company's costs may fluctuate, and constant price changing is not a viable strategy.

Markups

When middlemen use the term *markup*, they are referring to the difference between the average cost and price of all merchandise in stock, for a particular department, or for an individual item. The difference may be expressed in dollars or as a percentage. For example, a man's tie costs $14.50 and is sold for $25.23. The dollar markup is $10.73. The markup may be designated as a percent of the selling price or as a percent of the cost of the merchandise. In this example, the markup is 74 percent of cost ($10.73 / $14.50) or 42.5 percent of the retail price ($10.73 / $25.23).

Cost-Oriented Pricing of New Products

Certainly costs are an important component of pricing. No firm can make a profit until it covers its costs. However, the process of determining costs and setting a price based on costs does not take into account what the customer is willing to pay at the marketplace. This strategy is a bit of a trap for companies that develop products and continually add features to them, thus adding cost. Their cost-based approach leads them to add a percentage to the cost, which they pass on to customers in the form of a new, higher price. Then they are disappointed when their customers do not see sufficient value in the cost-based price.

Discounting Strategies

In addition to deciding about the base price of products and services, marketing managers must also set policies regarding the use of discounts and allowances. There are many different types of price reductions–each designed to accomplish a specific purpose. The major types are described below.

Quantity discounts are reductions in base price given as the result of a buyer purchasing some predetermined quantity of merchandise. A noncumulative quantity discount applies to each purchase and is intended to encourage buyers to make larger purchases. This means that the buyer holds the excess merchandise until it is used, possibly cutting the inventory cost of the seller and preventing the buyer from switching to a competitor at least until the stock is used. A cumulative quantity discount applies to the total bought over a period of time. The buyer adds to the potential discount with each additional purchase. Such a policy helps to build repeat purchases.

Both Home Depot and Lowe's offer a contractor discount to customers who buy more than $5,000 worth of goods. Home Depot has a tiered discount for painters, who can save as much as 20 percent off of retail once they spend $7,500.[3]

Seasonal discounts are price reductions given for out-of-season merchandise—snowmobiles discounted during the summer, for example. The intention of such discounts is to spread demand over the year, which can allow fuller use of production facilities and improved cash flow during the year.

Seasonal discounts are not always straightforward. It seems logical that gas grills are discounted in September when the summer grilling season is over, and hot tubs are discounted in January when the weather is bad and consumers spend less freely. However, the biggest discounts on large-screen televisions are offered during the weeks before the Super Bowl when demand is greatest. This strategy aims to drive impulse purchases of the large-ticket item, rather than spurring sales during the off-season.

Cash discounts are reductions on base price given to customers for paying cash or within some short time period. For example, a 2 percent discount on bills paid within 10 days is a cash discount. The purpose is generally to accelerate the cash flow of the organization and to reduce transaction costs.

Generally cash discounts are offered in a business-to-business transaction where the buyer is negotiating a range of pricing terms, including payment terms. You can imagine that if you offered to pay cash immediately instead of using a credit card at a department store, you wouldn't receive a discount.

Trade discounts are price reductions given to middlemen (e.g., wholesalers, industrial distributors, retailers) to encourage them to stock and give preferred treatment to an organization's products. For example, a consumer goods company might give a retailer a 20 percent discount to place a larger order for soap. Such a discount might also be used to gain shelf space or a preferred position in the store.

Calico Corners offers a 15 percent discount on fabrics to interior designers who are creating designs or products for their customers. They have paired this with a quantity-discounts program that offers gift certificates for buyers who purchase more than $10,000 in a year.

Personal allowances are similar strategies aimed at middlemen. Their purpose is to encourage middlemen to aggressively promote the organization's products. For example, a furniture manufacturer may offer to pay some specified amount toward a retailer's advertising expenses if the retailer agrees to include the manufacturer's brand name in the ads.

Some manufacturers or wholesalers also give retailers prize money called "spiffs," which can be passed on to the retailer's sales clerks as a reward for aggressively selling certain items. This is especially common in the electronics and clothing industries, where spiffs are used primarily with new products, slow movers, or high-margin items.

When employees in electronics stores recommend a specific brand or product to a buyer they may receive compensation from the manufacturer on top of their wages and commissions from the store.

Trade-in allowances also reduce the base price of a product or service. These are often used to help the seller negotiate the best price with a buyer. The trade-in may, of course, be of value if it can be resold. Accepting trade-ins is necessary in marketing many types of products. A construction company with a used grader worth $70,000 probably wouldn't buy a new model from an equipment company that did not accept trade-ins, particularly when other companies do accept them.

Price bundling is a very popular pricing strategy. The marketer groups similar or complementary products and charges a total price that is lower than if they were sold separately. Comcast and Direct TV both follow this strategy by combining different products and services for a set price. Similarly, Microsoft bundles Microsoft Word, Excel, Powerpoint, OneNote, and Outlook in the Microsoft Office Suite. The underlying assumption of this pricing strategy is that the increased sales generated will more than compensate for a lower profit margin. It may also be a way of selling a less popular product—like Microsoft OneNote—by

combining it with popular ones. Industries such as financial services, telecommunications, and software companies make very effective use of this strategy.

1. http://footwearnews.com/2014/busines...growth-144128/ ↵
2. http://www.forbes.com/sites/greatspe...0b103622d442d5 ↵
3. http://www.homedepot.com/c/Pro_Xtra ↵

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14.6: Putting It Together- Marketing Mix

Synthesis

In this module you have seen how businesses use the marketing mix to gain market share, enhance the value of their brand, and attract and retain customers in order to increase revenue and profit. Let's take a final look at this from the perspective of the most valuable brand in the world: Coca-Cola.

Coca-Cola is sold in more than two hundred countries around the world and represents nearly 43 percent of all carbonated beverages consumed in the United States annually. About 1.7 billion servings of Coke products are consumed every day. The **products** that Coca-Cola has used to capture the thirst of so many people go far beyond that iconic red can of soda. In fact, Coke makes so many different beverages that if you drank one per day, it would take you more than nine years to try them all. Coca-Cola has a product portfolio of more than 3,500 beverages (and 500 brands)—everything from sodas to energy drinks to soy-based drinks.[1]

The pricing strategy of Coca-Cola is what they refer to as "meet-the-competition pricing": Coca-Cola product **prices** are set around the same level as their competitors, because Coca-Cola has to be perceived as different but still affordable. Coca-Cola uses lower price points to penetrate new markets that are especially sensitive to price. They meet or beat the competition on price to raise brand awareness. Once the brand is established in the market, Coca-Cola repositions itself as the "premium" brand in comparison to its numerous competitors (Pepsi, for example). One way they accomplish this is by promoting a brand image of bringing intangible benefits in lifestyle, group affiliation, joy, and happiness . . . but the marketing strategy still focuses on an affordable premium product.

Coca-Cola has won a multitude of advertising industry awards for their innovative and effective promotional strategy. The **promotions** that Coca-Cola uses to further enhance its brand image and gain market share have included things like free hotel vouchers in Europe, Olympic sponsorship, the National Football League "Red Zone" promotion, and even "peel and win" stickers on Big Gulp cups at 7-Eleven.

Finally, the **place**, or distribution, of Coca-cola products is truly amazing. If you stacked up Coke's 2.8 million vending machines, they would take up 150.2 million cubic feet of space—the size of four Empire State Buildings.[2] But it's not just the vending machines that matter. The company achieves its global reach with local focus because of the strength of the Coca-Cola system, which comprises more than 250 bottling partners worldwide. Coca-Cola manufactures and sells concentrates, beverage bases, and syrups to bottling operations, while it owns the brands and is responsible for consumer brand marketing initiatives. Bottling partners manufacture, package, merchandise, and distribute the final branded beverages to customers and vending partners, who then sell Coca-Cola products to consumers. All bottling partners work closely with customers—grocery stores, restaurants, street vendors, convenience stores, movie theaters and amusement parks, among many others—to execute localized strategies developed in partnership with Coca Cola.[3]

What does this marketing mix result in for Coca Cola? The Coca-Cola brand is worth an estimated $83.8 billion. That's more than Budweiser, Subway, Pepsi, and KFC combined.[4]

Summary

This module covered the marketing mix in depth and the strategies companies use to develop effective marketing plans. Below is a summary of the topics covered in this module.

Product Marketing

Product is the core of the marketing mix. Product defines what will be priced, promoted, and distributed. If you are able to create and deliver a product that provides exceptional value to your target customer, the rest of the marketing mix is easier to manage. A successful product makes every aspect of a marketer's job more effective.

Pricing Strategies

When businesses make decisions about pricing, they can adopt profit-oriented pricing, competitor-oriented pricing, or customer-oriented pricing. Customer-oriented pricing focuses on the price-value equation: Value = Perceived Benefits – Perceived Costs. In

order to increase value, the business can either increase the perceived benefits or reduce the perceived costs. Today's marketing tends to favor customer-oriented pricing because it prioritizes the customer and the customer's perception of value.

Place: Distribution Channels

Distribution channels cover all the activities needed to transfer the ownership of goods and move them from the point of production to the point of consumption. These activities can be organized as five important channel flows: product flow, negotiation flow, ownership flow, information flow, and promotion flow. While channels can be very complex, there is a set of channel structures that can be identified in most transactions: the direct channel, the retail channel, the wholesale channel, and the agent channel.

Promotion: Integrated Marketing Communication (IMC)

There are many different marketing communication methods that can be used in the promotion mix. Integrated marketing communication is the process of coordinating all the promotional activity across these different methods. In this course you learned about seven common marketing communication: advertising, public relations, personal selling, sales promotion, digital marketing, direct marketing, and guerrilla marketing.

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1. https://us.coca-cola.com/ ↵
2. https://us.coca-cola.com/ ↵
3. https://us.coca-cola.com/ ↵
4. SEC Filings, 2015 ↵

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CHAPTER OVERVIEW

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15.4: Recruitment and Hiring
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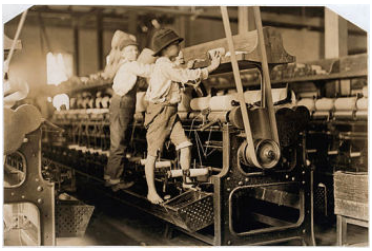
15.1: Why It Matters- Human Resource Management

Why explain the role of human resource management in planning, recruiting, and managing a workforce?



It's the early 1900s and you are twelve years old, living in an American city where industrialization has begun to boom. On Monday morning at 5 a.m., you line up with the rest of your family to begin your long workday at a textile factory. If it isn't terribly busy you will end your day around 8:00 p.m. You visit with your parents and siblings during your fifteen-minute lunch break. The factory where you work is not heated, has no ventilation system, and the windows can't be opened to let out the exhaust fumes from machinery. Since you are small, your responsibility is to climb in between the machinery and dislodge pieces of material that get caught in the gears and belts—while the machines are still running. You have to be especially careful because the only light in the factory is the sunlight that comes through the dirty windows. If you are not killed or maimed by the equipment, chances are good that your life will be cut short by the toxic fumes you inhale while in the factory. Every member of your family works there, including your four-year-old sister. Your father, the most highly skilled worker in the family, makes about ten cents per hour, your mother makes about half that since she's a woman, and you, as a child, make even less. Fortunately you don't have to worry about doing homework, because you don't attend school, and you'll learn to read and write only if your parents teach you on Sunday—the one day of the week when you don't go to work.

Similar grim working conditions continued for decades in America until labor unions formed and activists began to lobby for worker protections. It's hard, today, to imagine what those conditions really must have been like. We have always worked in conditions regulated for health and safety. We aren't forced to work for pennies per day. Understanding how far we have come in terms of employee rights and protections is an important context for thinking about human resource management. As you work through this section, try to keep this historical perspective in mind.

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15.2: Human Resource Management

What you'll learn to do: explain how the functions of human resource management contribute to business success

In this section you'll discover that human resource management involves a lot more than just hiring and firing employees. It's an integral part of any business's success and it requires a surprisingly diverse skill set to do it well.

Learning Objectives

- Explain how the functions of human resource management contribute to business success

Human Resource Management

What do all businesses have in common regardless of the product or service? Employees! Unless you are a sole proprietorship, you will have to navigate the process of planning for, recruiting, hiring, training, managing, and possibly firing employees. These responsibilities all fall under the heading of human resource management. **Human resource management** (**HRM** or **HR**) is essentially the management of human resources. It is a function in organizations designed to maximize employee performance in service of an employer's strategic objectives. HR is primarily concerned with the management of people within organizations, focusing on policies and on systems. HR departments in organizations typically undertake a number of activities, including employee benefits design, employee recruitment, training and development, performance appraisal, and rewarding (e.g., managing pay and benefit systems). HR also concerns itself with organizational change and industrial relations, that is, the balancing of organizational practices with requirements arising from collective bargaining and from governmental laws.

HR is a product of the human relations movement of the early twentieth century, when researchers began documenting ways of creating business value through the strategic management of the workforce. The function was initially dominated by transactional work, such as payroll and benefits administration, but due to globalization, company consolidation, technological advances, and further research, HR today includes strategic initiatives like talent management, industrial and labor relations, and diversity and inclusion.

Most companies focus on lowering employee turnover and on retaining the talent and knowledge held by their workforce. New hiring not only entails a high cost but also increases the risk of a newcomer not being able to replace the person who worked in a position before. HR departments strive to offer benefits that will appeal to workers, thus reducing the risk of losing corporate knowledge. Businesses are moving globally and forming more diverse teams. It is the role of human resources to make sure that these teams can function and people are able to communicate cross-culturally and across borders. Due to changes in business, current topics in human resources are diversity and inclusion as well as using technology to advance employee engagement.

In short, HR involves maximizing employee productivity. HR managers may also focus on a particular aspect of HRM, such as recruiting, training, employee relations, or benefits. Recruiting specialists are in charge of finding and hiring top talent. Training and development professionals ensure that employees are trained and receive ongoing professional development. This takes place through training programs, performance evaluations, and reward programs. Employee relations deals with employee concerns and incidents such as policy violations, sexual harassment, and discrimination. Benefit managers develop compensation structures, family-leave programs, discounts, and other benefits available to employees. At the other end of the spectrum are HR generalists who work in all areas or as labor relations representatives for unionized employees.

Core Functions of HR

Human resources (HR) professionals conduct a wide variety of tasks within an organizational structure. A brief rundown on the core functions of human resource departments will be useful in framing the more common activities a human resource professional will conduct. The core functions can be summarized as follows:

Staffing

This includes the activities of hiring new full-time or part-time employees, hiring contractors, and terminating employee contracts.

Staffing activities include:

- Identifying and fulfilling talent needs (through recruitment, primarily)

- Utilizing various recruitment technologies to acquire a high volume and diverse pool of candidates (and to filter them based on experience)
- Protecting the company from lawsuits by satisfying legal requirements and maintaining ethical hiring practices
- Writing employee contracts and negotiating salary and benefits
- Terminating employee contracts when necessary

Training and Professional Development

On-boarding new employees and providing professional development opportunities is a key investment for organizations, and HR is charged with seeing that those efforts and resources are well spent and utilized.

Development activities include:

- Training and preparing new employees for their roles
- Providing training opportunities (internal training, educational programs, conferences, etc.) to keep employees up to date in their respective fields
- Preparing management prospects and providing feedback to employees and managers

Compensation

Salary and benefits are also within the scope of human resource management. This includes identifying appropriate compensation based on role, performance, and legal requirements.

Compensation activities include:

- Setting compensation levels to be competitive and appropriate within the market, using benchmarks such as industry standards for a given job function
- Negotiating group health insurance rates, retirement plans, and other benefits with third-party providers
- Discussing raises and other compensation increases and/or decreases with employees in the organization
- Ensuring compliance with legal and cultural expectations when it comes to employee compensation

Safety and Health

HR managers are also responsible for understanding and implementing the best safety and health practices in their industry and addressing any relevant employee concerns.

Safety and health activities include the following:

- Ensuring compliance with legal requirements based on job function for safety measures (i.e., hard hats in construction, available counseling for law enforcement, appropriate safety equipment for chemists, etc.). Many of these requirements are specified by the Occupational Safety and Health Administration (OSHA).
- Implementing new safety measures when laws change in a given industry
- Discussing safety and compliance with relevant government departments
- Discussing safety and compliance with unions

Employee and Labor Relations

Defending employee rights, coordinating with unions, and mediating disagreements between the organization and its human resources are also core HR functions.

Employee and labor relations activities include:

- Mediating disagreements between employees and employers
- Mediating disagreements between employees and other employees
- Investigating claims of harassment and other workplace abuses
- Discussing employee rights with unions, management, and stakeholders
- Acting as the voice of the organization and/or the voice of the employees during any broader organizational issues pertaining to employee welfare

In this module you will explore each of these core functions in greater depth and also learn about the main challenges facing today's HR professional.

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15.3: Human Resources and Laws

What you'll learn to do: summarize and discuss key laws affecting human resource management

Federal and state legislation have a big impact on businesses. There is an important body of anti-discrimination and labor laws that have a particular effect on human resource management. You'll learn about those laws here.

Learning Objectives

- Summarize key anti-discrimination legislation
- Discuss key laws affecting human resource management

Employment Legislation

President Lyndon Johnson shakes hands with Martin Luther King Jr. after presenting him with one of the pens used to sign the Civil Rights Act of 1964.

What happens when businesses make decisions that violate laws and regulations designed to protect working Americans? In some cases it costs businesses a great deal of money. Consider the following headlines:

- South San Francisco Walgreens fired longtime employee with diabetes over a $1.39 bag of chips, federal agency charged.[1] The cost to Walgreens? $180,000.
- United Airlines pays $850,000 to a class of current and former employees with disabilities who were denied employment opportunities at San Francisco International Airport.[2]
- A Domino's franchisee agreed to pay 61 delivery employees $1.28 million to settle a wage-and-hour lawsuit.[3]

In other cases, the monetary damage may be minimal, but the reputation of the business as a "great place to work" becomes tarnished, and HR professionals have a difficult time recruiting and retaining quality employees. Businesses that disregard worker protections may find themselves on a list of "worst places to work." Such is the case with the retail clothing store Forever 21.

24/7 Wall St., a financial news service, analyzed thousands of employee reviews from jobs-and-career Web site Glassdoor. Based on employee reviews of more than 540,000 companies, the worst U.S. company were Family Dollar Stores, Express Scripts, and Forever 21.[4]

Regarding Forever 21, this year's report found the following:

> *"Over the years, the store has been hit with several high-profile lawsuits, including several filed by employees. In 2012, five Forever 21 employees filed a class-action lawsuit against the company. The plaintiffs claimed that they and their coworkers were routinely detained in the store during lunch breaks and after their shifts without overtime pay so managers could search their bags for stolen merchandise—a part of the company's former loss-prevention policy. Indeed, many employees on Glassdoor complain of not getting to leave the store until 2:00 a.m. or later, hours after the stores close, often receiving no overtime pay for the extra hours.[5]"*

Anti-Discrimination Legislation

Protecting workers against unfair treatment is at the heart of U.S. anti-discrimination legislation. In 1964, the United States Congress passed the first Civil Rights Act. In 1963 when the legislation was introduced, the act **only** forbade discrimination on the basis of sex and race in hiring, promoting, and firing. However, by the time the legislation was finally passed on July 2, 1964, Section 703 (a) made it unlawful for an employer to "fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions or privileges or employment, because of such individual's race, color, religion, sex, or national origin."

Over the years, amendments to the original act have expanded the scope of the law, and today the Equal Employment Opportunity Commission (discussed below) enforces laws that prohibit discrimination based on an *expanded* list of protected classes that

includes disability, veteran status, citizenship, familial status, and age. Anti-discriminations laws today apply not only to hiring, promoting, and firing but also to wage setting, testing, training, apprenticeships, and any other terms or conditions of employment.

While the Civil Rights Act of 1964 did not mention the words *affirmative action*, it did authorize the bureaucracy to makes rules to help end discrimination. **Affirmative action** "refers to both mandatory and voluntary programs intended to affirm the civil rights of designated classes of individuals by taking positive action to protect them" from discrimination. The first federal policy of race-conscious affirmative action emerged in 1967 and required government contractors to set "goals and timetables" for integrating and diversifying their workforce. Similar policies began to emerge through a mix of voluntary practices and federal and state policies in employment and education. These include government-mandated, government-sanctioned, and voluntary private programs that tend to focus on access to education and employment, specifically granting special consideration to historically excluded groups such as racial minorities or women. The impetus toward affirmative action is redressing the disadvantages associated with past and present discrimination. A further impetus is the desire to ensure that public institutions, such as universities, hospitals, and police forces, are more representative of the populations they serve.

In the United States, affirmative action tends to emphasize not specific quotas but rather "targeted goals" to address past discrimination in a particular institution or in broader society through "good-faith efforts . . . to identify, select, and train potentially qualified minorities and women." For example, many higher education institutions have voluntarily adopted policies that seek to increase recruitment of racial minorities. Another example is executive orders requiring some government contractors and subcontractors to adopt equal opportunity employment measures, such as outreach campaigns, targeted recruitment, employee and management development, and employee support programs.

Title VII of the act created the **Equal Employment Opportunity Commission (EEOC)** to implement the law and subsequent legislation has expanded the role of the EEOC. The EEOC, as an independent regulatory body, plays a major role in dealing with the issue of employment discrimination. Since its creation in 1964, Congress has gradually extended EEOC powers to include investigatory authority, creating conciliation programs, filing lawsuits, and conducting voluntary assistance programs.

Today the regulatory authority of the EEOC includes enforcing a range of federal statutes prohibiting employment discrimination, including the following:

- **Civil Rights Act of 1964**, which prohibits employment discrimination on the basis of race, color, religion, sex, or national origin. The prohibition against **sexual harassment** falls under Title VII of this act. As defined by the EEOC, "It is unlawful to harass a person (an applicant or employee) because of that person's sex." Harassment can include "sexual harassment" or unwelcome sexual advances, requests for sexual favors, and other verbal or physical harassment of a sexual nature.
- **Age Discrimination in Employment Act (ADEA) of 1967**, and its amendments, which prohibits employment discrimination against individuals 40 years of age or older. The ADEA's protections apply to both employees and job applicants. Under the ADEA, it is unlawful to discriminate against a person because of his/her age with respect to any term, condition, or privilege of employment, including hiring, firing, promotion, layoff, compensation, benefits, job assignments, and training. The ADEA permits employers to favor older workers based on age even when doing so adversely affects a younger worker who is 40 or older.
- **Equal Pay Act (EPE) of 1963**, which prohibits discrimination on the basis of gender in compensation for substantially similar work under similar conditions. In essence, men and women doing equal jobs must receive the same pay. According to the Bureau of Labor Statistics, women's salaries vis-à-vis men's have risen dramatically since the EPA's enactment, from 62 percent of men's earnings in 1970 to 83 percent in 2014. Nonetheless, the EPA's equal pay for equal work goals have not been completely achieved.
- **Americans with Disabilities Act (ADA) of 1990**, which prohibits employment discrimination on the basis of disability in both the public and private sector, excluding the federal government. The ADA also requires covered employers to provide reasonable accommodations to employees with disabilities and imposes accessibility requirements on public accommodations. "A reasonable accommodation" is defined by the U.S. Department of Justice as "any modification or adjustment to a job or the work environment that will enable a qualified applicant or employee with a disability to participate in the application process or to perform essential job functions.
- **Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA)**, which protects the civilian employment of active and reserve military personnel in the United States called to active duty. The law applies to all United States uniformed services and their respective reserve components.

These laws were enacted to protect the average working citizen, but the existence of laws doesn't guarantee that employers will follow them. EEOC acts as a watchdog organization and steps in to assist employees who believe they have suffered workplace discrimination. Just how often do employees turn to the EEOC?

In fiscal year 2014, the EEOC received 88,778 charges of workplace discrimination. During that time, the percentage of charges alleging retaliation reached the highest level ever: 42.8 percent. The percentage of charges alleging race discrimination—the second most common allegation—has remained steady at approximately 35 percent. In fiscal year 2014, the EEOC collected $296.1 million in total monetary relief through its enforcement program prior to filing lawsuits. The number of lawsuits filed by the EEOC's Office of General Counsel throughout the nation was 133, up slightly from the previous two fiscal years. Monetary relief from cases litigated, including settlements, totaled $22.5 million.

"Behind these numbers are individuals who turned to the EEOC because they believe that they have suffered unlawful discrimination," said EEOC Chair Jenny R. Yang. "The EEOC remains committed to meaningful resolution of charges and strategic enforcement to eliminate barriers to equal employment opportunity."[6]

Labor and Safety Legislation

There are many other laws designed to regulate the employer-employee relationship. Several are described below:

- **National Labor Relations Act of 1935**, which created collective bargaining in labor-management relations and limited the rights of management interference in the right of employees to have a collective bargaining agent. In essence, this act both legitimated and helped regulate labor union activities.
- **Fair Labor Standards Act of 1938**, which established a national minimum wage, forbade "oppressive" child labor, and provided for overtime pay in designated occupations. It declared the goal of assuring "a minimum standard of living necessary for the health, efficiency, and general well-being of workers." Today these standards affect more than 130 million workers, both full-time and part-time, in the private and public sectors.
- **Occupational Safety and Health Act of 1970 (OSHA)**, which requires employers to maintain workplace conditions or adopt practices reasonably necessary to protect workers on the job; to be familiar with and comply with standards applicable to their establishments; and ensure that employees have and use personal protective equipment when required for safety and health. The major areas covered by OSHA standards are toxic substances, harmful physical agents, electrical hazards, fall hazards, hazards associated with trenches and digging, hazardous waste, infectious disease, fire and explosion dangers, dangerous atmospheres, machine hazards, and confined spaces.
- **Immigration Reform and Control Act of 1986**, which requires employers to verify the identity and employment authorization of all new hires, whether they are citizens or noncitizens. Employers must do this by ensuring proper completion of Form I-9 for each individual they hire for employment in the United States.
- **Family and Medical Leave Act of 1993**, which requires businesses with fifty or more employees to provide up to twelve weeks of unpaid leave per year upon the birth or adoption of an employee's child or in the event of serious illness to a parent, spouse, or child.

The Top Five Manager Mistakes That Cause Lawsuits

There has been an explosion in the number of employee lawsuits in the U.S. during the past few years. According to the EEOC, employee lawsuits have risen 425 percent since 1995, and the trend does not appear to be diminishing. Sadly, many of these lawsuits can be avoided because manager mistakes are at the center of many of them. That's why it's important to know at least the basics of employment law. In the following video, Business Management Daily's editorial director Pat DiDomenico describes the top five manager mistakes that cause lawsuits.

1. https://www.eeoc.gov/eeoc/newsroom/release/7-2-14b.cfm ↵
2. www.eeoc.gov/eeoc/history/45th/ada20/ada_cases.cfm ↵
3. http://www.nytimes.com/2014/02/01/nyregion/dominos-franchise-settles-delivery-workers-lawsuit-for-1-28-million.html?_r=1 ↵
4. http://247wallst.com/special-report/2016/06/10/the-worst-companies-to-work-for-2/6/ ↵
5. http://247wallst.com/special-report/2016/06/10/the-worst-companies-to-work-for-2/6/ ↵
6. https://www.eeoc.gov/eeoc/newsroom/release/2-4-15.cfm ↵

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15.4: Recruitment and Hiring

What you'll learn to do: discuss how organizations can effectively recruit and hire employees

In this section you'll learn how organizations approach the tasks of recruiting and hiring the best employees.

Learning Objectives

- Describe common recruitment strategies
- Describe the components of the hiring process

Diversity in Human Resources

What Is Diversity?

The term *diversity* often generates controversy, confusion, and tension. What does it mean? Is it the same as affirmative action?

When people refer to diversity, they may be thinking first of ethnicity and race, and then, of gender; however, diversity is much broader than that. The following definition, from *Workforce America! Managing Employee Diversity As a Vital Resource*, does a good job of capturing the subjective nature of the term: Diversity is "otherness or those human qualities that are different from our own and outside the groups to which we belong, yet present in other individuals and groups." In other words, diversity can apply to anyone you perceive to be different from yourself. Dimensions of diversity include, but are not limited to age, ethnicity, ancestry, gender, physical abilities/qualities, race, sexual orientation, educational background, geographic location, income, marital status, military experience, religious beliefs, parental status, and work experience.[1]

How Businesses Benefit from Diversity

There are many arguments for fostering diversity in business, including the availability of talent, the enhancement of interpersonal innovation, risk avoidance, and appealing to a global customer base. The business case for diversity is driven by the view that diversity brings substantial potential benefits, such as better decision making, improved problem solving, and greater creativity and innovation, which lead to enhanced product development and more successful marketing to different types of customers.

Innovation. It is widely noted that diverse teams lead to more innovative and effective ideas and implementations. The logic behind this is relatively simple. Innovative thinking requires individuals to go outside of the normal paradigms of operation, using diverse perspectives to reach new and creative thinking. A group of similar individuals with similar skills is much less likely to stumble across or generate new ideas that lead to innovation. Similarity can cause groupthink, which diminishes creativity.

Localization. Some theorize that, in a global marketplace, a company that employs a diverse workforce is better able to understand the demographics of the global consumer marketplace it serves, and is therefore better equipped to thrive in that marketplace than a company that has a more limited range of employee demographics. With the emerging markets around the world demonstrating substantial GDP growth, organizations need local talent to enter the marketplace and to communicate effectively. Individuals from a certain region will have a deep awareness of the needs in that region, as well as a similar culture, enabling them to add considerable value.

Adaptability. Finally, organizations must be technologically and culturally adaptable in the modern economy. This is crucial to reacting to competitive dynamics quickly and staying ahead of industry trends. Diversity fosters creative thinking and improved decision making through a deeper and more comprehensive worldview. A company willing to diversify draws from a larger talent pool and hires individuals with diverse skill sets. The value of this, particularly at the managerial level, is enormous.

The Role of Human Resource Management

When it comes to the workplace, the human resource department has a great deal of responsibility in managing the overall diversity of the organization. Human resources should consider diversity within the following areas:

- Hiring
- Promotion
- Compensation equality
- Training
- Employee policies
- Legal regulations

- Ensuring accessibility of important documents (e.g., translating human resource materials into other languages so all staff can read them)

The role of human resources is to ensure that all employee concerns are being met and that employee problems are solved when they arise. Human resource professionals must also pursue corporate strategy and adhere to legal concerns when hiring, firing, paying, and regulating employees. This requires careful and meticulous understanding of both the legal and organizational contexts as they pertain to diversity management.

Challenges to Diversity

There are various challenges to achieving diversity in the workplace, ranging from the difficulties of defining the term to the individual, interpersonal, and organizational challenges involved in implementing diversity practices. Though the advantages of diversity are well established, establishing a more diverse workforce brings with it obstacles, in both the assimilation of new cultures into the majority and wage-equality and upper-level opportunities across the minority spectrum. Some of the most common challenges to building a diverse workforce are the following:

- **Stereotypes.** One challenge of creating diversity is the biases individuals in the organization may have about others similar to or different from them. This is essentially a tendency to stereotype, which significantly narrows the worldview of the individuals within the organization.
- **Culture.** Managers must understand the customs and cultural norms of employees and ensure that they don't violate important cultural rules. It is the role of the managers to change the existing organizational culture to one of diversity and inclusion.
- **Communication.** Whether via language or cultural signals, communication can be especially challenging in the interpersonal arena. Ensuring that all professionals (human resources, management, etc.) have access to resources for localizing or translating issues is a significant challenge in many situations. Poor cross-cultural communication can lead to employee misunderstandings or workplace inefficiencies.

While diversity has clear benefits from an organizational perspective, an additional challenge with diversity comes from mismanagement. Due to the legal framework surrounding diversity in the workplace, there is a potential threat involving the neglect of relevant rules and regulations. Fair, ethical, and nondiscriminatory hiring practices and pay equity for all employees are absolutely essential for managers and human resource professionals to understand and uphold. The legal ramifications of missteps in this particular arena can have high fiscal, branding, and reputation costs.

Recruitment

Recruitment of talented employees is an essential part of any company's ability to achieve success and maintain standards within an organization. Recruiting workers consists of actively compiling a diverse pool of potential candidates who can be considered for employment. A good recruitment policy will do this in a timely, cost-efficient manner. The ultimate goal of any human resources recruitment policy is to develop relationships with potential employees before they may actually be needed while keeping an eye on the costs of doing so. In different industries, the constant need for talent creates a highly competitive marketplace for individuals, and it is important for any manager to be aware of these factors as they develop recruitment programs and policies. As retirement among baby boomers becomes increasing prevalent, victory in the "war for talent" will depend greatly on recruitment policies.

Methods of Recruitment

There are two principal ways to recruit workers: internally and externally. Most companies will actively use both methods, ensuring opportunities for existing employees to move up in the organization while at the same time finding new talent. Depending on the time frame and the specialization of the position to fill, some methods will be more effective than others. In either case, the establishment of a comprehensive job description for every position the company seeks to fill will help to narrow the scope of the search and attract more qualified candidates—which contributes to search efficiency.

Internal recruitment is often the most cost-effective method of recruiting potential employees, as it uses existing company resources and talent pool to fill needs and therefore may not incur any extra costs. This is done in two principal ways:

- **Advertising job openings internally:** This is a method of using existing employees as a talent pool for open positions. It carries the advantage of reallocating individuals who are qualified and familiar with the company's practices and culture while

at the same time empowering employees within the organization. It also shows the company's commitment to, and trust in, its current employees taking on new tasks.

- **Using networking:** This method can be used in a variety of different ways. First, this recruitment technique involves simply posting the question to existing employees about whether anyone knows of qualified candidates who could fill a particular position. Known as employee referrals, this method often includes giving bonuses to the existing employee if the recommended applicant is hired. Another method uses industry contacts and membership in professional organizations to help create a talent pool via word-of-mouth information regarding the needs of the organization.

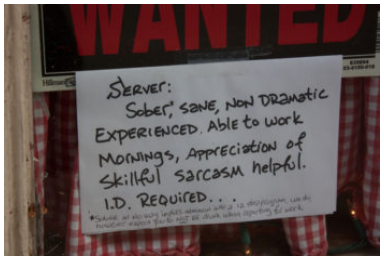
External recruitment focuses on searching outside the organization for potential candidates and expanding the available talent pool. The primary goal of external recruitment is to create diversity and expand the candidate pool. Although external recruitment methods can be costly to managers in terms of dollars, the addition of a new perspective within the organization can bring many benefits that outweigh the costs. External recruitment can be done in a variety of ways:

- **Online recruitment:** The use of the Internet to find a talent pool is quickly becoming the preferred way of recruiting, due to its ability to reach such a wide array of applicants quickly and cheaply. First, the use of the company Web site can enable a business to compile a list of potential applicants who are very interested in the company while at the same time giving them exposure to the company's values and mission. In order to be successful using this recruitment method, a company must ensure that postings and the process for submitting resumes are as transparent and simple as possible. Another popular use of online recruiting is through career Web sites (e.g., Monster.com or Careerbuilder.com). These sites charge employers a set fee for a job posting, which can remain on the Web site for specified period of time. These sites also carry a large database of applicants and allow clients to search their database to find potential employees.
- **Traditional advertising:** This often incorporates one or many forms of advertising, ranging from newspaper classifieds to radio announcements. It is estimated that companies spend USD 2.18 billion annually on these types of ads.[2] Before the emergence of the Internet, this was the most popular form of recruitment for organizations, but the decline of newspaper readership has made it considerably less effective.[3]
- **Job fairs and campus visits:** Job fairs are designed to bring together a comprehensive set of employers in one location so that they may gather and meet with potential employees. The costs of conducting a job fair are distributed across the various participants and can attract an extremely diverse set of applicants. Depending on the proximity to a college or university, campus visits help to find candidates who are looking for the opportunity to prove themselves and have the minimum qualifications, such as a college education, that a firm seeks.
- **Headhunters and recruitment services:** These outside services are designed to compile a talent pool for a company; however they can be extremely expensive. Although these service can be extremely efficient in providing qualified applicants for specialized or highly demanded job positions, the rate for the services provided by headhunters can range from 20 percent to 35 percent of the new recruit's annual salary if the individual is hired.[4]

No matter how a company decides to recruit, the ultimate test is the ability of a recruitment strategy to produce viable applicants. Each manager will face different obstacles in doing this. It is important to remember that recruiting is not simply undertaken at a time of need for an organization but rather is an ongoing process that involves maintaining a talent pool and frequent contact with candidates.

The Hiring Process

Selective Hiring



In recruiting, it is beneficial to attract not only a large number of applicants but a group of individuals with the necessary skills and requirements for the position. After obtaining a substantial, qualified applicant base, managers need to identify those applicants with the highest potential for success at the organization. According to Pfeffer and Veiga, selecting the best person for the job is an extremely critical part of the human resources inflow process.[5] Selective hiring helps prevent the costly turnover of staff and increases the likeliness of high employee morale and productivity.

In order to evaluate the fit, it is important for managers to create a list of relevant criteria for each position before beginning the recruitment and selection process. Each job description should be associated with a list of critical skills, behaviors, or attitudes that will make or break the job performance. When screening potential employees, managers need to select based on cultural fit and attitude as well as on technical skills and competencies. There are some U.S. companies,

such as Southwest Airlines, that hire primarily on the basis of attitude because they espouse the philosophy that you *hire for attitude and train for skill*. According to former CEO Herb Kelleher, "We can change skill levels through training. We can't change attitude."[6] After determining the most important qualifications, managers can design the rest of the selection process so that it aligns with the other human resource processes.

Screening

Managers strive to identify the best applicants at the lowest cost. Companies have a range of processes for screening potential employees, so managers must determine which system will generate the best results. The methods of screening vary both in levels of effectiveness and in cost of application. In addition to biographical information, companies can conduct background checks or require testing. Because of the costs associated with these measures, companies try to narrow down the number of applicants in the screening process, choosing only the most suitable candidates for interviews. In the United States, the selection process is subject to Equal Employment Opportunity guidelines, which means that companies must be able to show that the process is valid, reliable, related to critical aspects of the the job, and nondiscriminatory. Taking such measures helps companies avoid litigation.

Interviews

As mentioned, it is important to first define the skills and attributes necessary to succeed in the specified position, then develop a list of questions that directly relate to the job requirements. The best interviews follow a structured framework in which each applicant is asked the same questions and is scored with a consistent rating process. Having a common set of information about the applicants to compare after all the interviews have been conducted helps hiring managers avoid prejudice and ensure that all interviewees are given a fair chance.[7] Structured interviews also helps managers avoid illegal questions, such as asking a woman whether she is pregnant. Many companies choose to use several rounds of screening with different interviewers to discover additional facets of the applicant's attitude or skill as well as develop a more well-rounded opinion of the applicant from diverse perspectives. Involving senior management in the interview process also acts as a signal to applicants about the company culture and value of each new hire. There are two common types of interviews: behavioral and situational.

Behavioral Interviews

In a behavioral interview, the interviewer asks the applicant to reflect on his or her past experiences.[8] After deciding what skills are needed for the position, the interviewer will ask questions to find out if the candidate possesses these skills. The purpose of behavioral interviewing is to find links between the job's requirement and how the applicant's experience and past behaviors match those requirements. The following are examples of behavioral interview questions:

> *"Describe a time when you were faced with a stressful situation. How did you handle the situation?*
>
> *Give me an example of when you showed initiative and assumed a leadership role?"*

Situational Interviews

A situational interview requires the applicant to explain how he or she would handle a series of hypothetical situations. Situational-based questions evaluate the applicant's judgment, ability, and knowledge.[9] Before administering this type of interview, it is a good idea for the hiring manager to consider possible responses and develop a scoring key for evaluation purposes. Examples of situational interview questions:

> *"You and a colleague are working on a project together; however, your colleague fails to do his agreed portion of the work. What would you do?*
>
> *A client approaches you and claims that she has not received a payment that supposedly had been sent five days ago from your office. She is very angry. What would you do?"*

Selection Tests

For some companies, understanding the applicant's personality, values, and motivation for wanting the job is a critical part of the hiring decision. For some positions, although technical aptitude is required, the candidate's attitude is often just as important. Under these circumstances, companies may use behavioral assessments and personality profiles. The goal of these assessments is to predict how the individual will interact with their coworkers, customers, and supervisors. Tests such as the IPIP (International Personality Item Pool) and Wonderlic are popular tools that provide an analysis of an applicant's personality, attitudes, and

interpersonal skills; however, it is *critical* that the tests be administered, scored, and interpreted by a licensed professional. Other selection tests used in hiring may include cognitive tests, which measure general intelligence, work sample tests, which demonstrate the applicant's ability to perform specific job duties, and integrity tests, which measure honesty.

Background Checks

Background checks are a way for employers to verify the accuracy of information provided by applicants in résumés and applications. Information gathered in background checks may include employment history, education, credit reports, driving records, and criminal records. Employers must obtain written consent from the applicant before conducting a background check, and the information gathered in a background check should be relevant to the job.

Evaluation

Employers may choose to use just one or a combination of the screening methods to predict future job performance. It is important for companies to use metrics to assess the effectiveness of their selective hiring process. This provides a benchmark for future performance as well as a means of evaluating the success of a particular method. Companies can continuously improve their selection practices to ensure that they hire people who will successfully meet job requirements as well as fit into the organizational culture. If companies are not successful in their hiring practices, high turnover, low employee morale, and decreased productivity will result. Research shows that the "degree of cultural fit and value congruence between job applicants and their organizations significantly predicts both subsequent turnover and job performance."[10] Thus, companies need to assess their hiring in terms of technical success as well as cultural fit. Evaluating the hiring process will help ensure continuing success, because human capital is often a company's most important asset.

How do hiring decisions affect a company's success? Zappos is well known for consistently providing excellent customer service. In the video below, CEO Tony Hsieh explains how company values drive their hiring decisions.

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15.5: Training, Development, and Rewards

What you'll learn to do: discuss effective approaches to training, developing, and rewarding employees

In this section you'll learn about employee training, professional development, performance appraisals, and employee compensation.

Learning Objectives

- Describe different approaches to professional development
- Summarize different forms of employee compensation

Training and Professional Development

A medieval baker with his apprentice

In the late Middle Ages, craft guilds allowed master craftsmen to employ young people as an inexpensive form of labor in exchange for food, lodging, and formal training in the craft. Consequently, if a young man or woman wanted to obtain skills as a craftsperson, he or she would spend at least seven years as an apprentice, supervised by a master craftsman before being released to work independently. Clearly the world of work has changed and so has the way that individuals obtain and hone their workplace skills.

Training

Training is teaching, or developing in oneself or others, any skills and knowledge that relate to specific useful competencies. Training has specific goals of improving one's capability, capacity, productivity, and performance. In business, training is the investment of resources in the employees of a company so they are better equipped to perform their job. The types of resources invested may include time and money to develop, implement, and evaluate training programs.

Benefits of Training

Training can be a source of a competitive advantage for a company. The primary benefit to the company is the result of an accumulation of smaller benefits. Training provides greater skill and knowledge to employees, which translate to improved job performance. Improved job performance, in turn, means greater efficiency, fewer errors, better productivity. The end result is reduced costs and higher profits. The company is not the only beneficiary of employee training, though; the employee can realize rewards, too.

The well-trained employee acquires an advantage for him- or herself. By participating in training, employees can deepen or expand their existing skill set and increase their understanding of the organization. In addition, a well-trained employee may be able to take advantage of internal promotion opportunities and becomes more marketable if he or she leaves the company. Other potential benefits are listed below:

- Increased job satisfaction and morale among employees
- Increased employee motivation
- Increased efficiencies in processes, resulting in financial gain
- Increased capacity to adopt new technologies and methods
- Increased innovation in strategies and products
- Reduced employee turnover
- Enhanced company image, e.g., building a reputation as a "great place to work"
- Risk management, e.g. training about sexual harassment, diversity training[1]

Need for Training

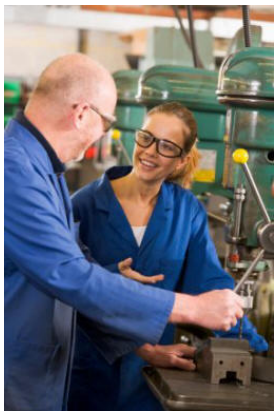
The need for training exists in every business. However the nature of training varies depending on the type of business and operations involved. For example, a manufacturing company may have a need for technical skills training while an insurance company may emphasize customer service training. So, how does a company determine what sort of training is needed? The process begins with a **training needs assessment**. A training needs assessment is a systematic and objective analysis of both the employee and organizational knowledge, skills, and abilities to identify gaps or areas of need.

Generally, training needs assessments are conducted as follows:

1. **Identify the need.** In this first step, the assessor looks for answers to questions such as: Why is the needs assessment being conducted? What is the desired result? What issues are trying to be addressed? Will training alone resolve the issues?
2. **Perform a gap analysis.** This involves comparing current knowledge, skills, and abilities against company standards. Training assessors may use HR records, interviews, questionnaires, or observation to identify gaps.
3. **Assess training options.** Once completed, the assessment will present a list of options for training that management can evaluate based on criteria such as cost and duration.

Not all training is the result of a needs assessment. Unforeseen circumstances may create an immediate need for training. For example, consider the Wells Fargo scandal of 2016, when it came to light that employees had secretly created millions of unauthorized bank and credit card accounts in order to generate bank fees and boost their sales figures. The bank fired 5,300 employees and had to put in place a rapid training and retraining program to mitigate the legal consequences of their employees' actions. Other situations that might compel a company to conduct impromptu training are changes in legal requirements, new regulations, natural disasters or other crises.

Types of Training



The goal of training is for the trainee to acquire relevant knowledge, skills, and competencies from the trainer as a result of being taught vocational or practical skills. More generally, training is aimed at improving the trainee's capability, capacity, and performance.

Generally training is categorized as on-the-job or off-the-job:

On-the-job training takes place in a normal working situation, using the actual tools, equipment, documents, or materials that trainees will use once they are fully trained. On-the-job training is not limited to, but is most commonly used for, technical or skills training.

Off-the-job training takes place away from the normal work situation, and as a result, the employee is not a directly productive worker while such training takes place. Businesses often cite this as one of the disadvantages of off-the-job training. However, this type of training has the advantage of allowing people to get away from work and concentrate more thoroughly on the training itself. Off-the-job of training has proven very effective in helping people acquire and master new concepts and ideas.

Professional Development

In addition to the basic training required for a trade, occupation, or profession, the labor market recognizes the need to continue training beyond initial qualifications in order to maintain, upgrade, and update skills throughout working life. This is known as professional development.

Professional development refers to skills and knowledge attained for both personal development and career advancement. Professional development encompasses all types of facilitated learning opportunities, ranging from college degrees and formal coursework to conferences and workshops.

Individuals who take part in professional development run the gamut from teachers to military officers. Individuals may pursue professional development because of an interest in lifelong learning, a sense of moral obligation, to maintain and improve professional competence, enhance career progression, keep abreast of new technology and practice, or to comply with professional regulatory organizations. In fact, there are many professions that have requirements for annual professional development to renew a license or certification, such as accountants, lawyers, and engineers.

There are a variety of approaches to professional development, including consultation, coaching, communities of practice, lesson study, mentoring, reflective supervision, and technical assistance. Professional development may include formal types of vocational education—typically post-secondary or technical training leading to a qualification or credential required to obtain or retain employment. Professional development may also come in the form of pre-service or in-service professional development programs. These programs may be formal or informal, group or individual. It's possible to pursue professional development on one's own, or through the company's human resource departments. Professional development on the job may develop or enhance "process skills"—sometimes referred to as leadership skills—as well as task skills. Some examples of process skills are effectiveness skills, team-functioning skills, and systems-thinking skills.

The twenty-first century has seen a significant growth in online professional development. Content providers have become well informed about using technology in innovative ways, incorporating collaborative platforms such as discussion boards and Wikis to maximize participant interaction. These content providers offer training on topics ranging from sexual harassment awareness to promoting diversity in the workplace. The ability to customize training for a business or industry has placed these providers in a position to supplement or even replace in-house training departments. Because businesses can purchase access on an as-needed basis for as many or as few employees as necessary, the cost of training is reduced. Thus, businesses can provide more training and professional development opportunities to their employees at reduced costs and at times that are more convenient for both the employer and employee.

Human resource management is all about increasing employee performance to their highest level corresponding to their role in the organization. Consequently, the importance of training to the organization and as a key function of HR management cannot be understated.

Performance Appraisals

The Purpose of Performance Appraisals

A **performance appraisal** (PA) or performance evaluation is a systematic and periodic process that assesses an individual employee's job performance and productivity, in relation to certain pre-established criteria and organizational objectives. Other aspects of individual employees are considered as well, such as organizational citizenship behavior, accomplishments, potential for future improvement, strengths, and weaknesses. A PA is typically conducted annually. However, the frequency of an evaluation, and policies concerning them, varies widely from workplace to workplace. Sometimes an evaluation will be given to a new employee when a probationary period ends, after which they may be conducted on a regular basis (such as every year). Usually, the employee's supervisor (and frequently, a more senior manager) is responsible for evaluating the employee, and he or she does so by scheduling a private conference to discuss the evaluation. The interview functions as a way of providing feedback to employees, counseling and developing employees, and conveying and discussing compensation, job status, or disciplinary decisions.

Historically, performance appraisals have been used by companies for a range of purposes, including salary recommendations, promotion and layoff decisions, and training recommendations.[2] In general, "performance elements tell employees what they have to do, and standards tell them how well they have to do it."[3] This broad definition, however, can allow for appraisals to be ineffective, even detrimental, to employee performance. "Second only to firing an employee, managers cite performance appraisal as the task they dislike the most," and employees generally have a similar feeling.[4] One key item that is often forgotten during the appraisal process (by managers and employees alike) is that the appraisal is for improvement, not blame or harsh criticism.[5]

Developing an Appropriate Appraisal Process

One significant problem in creating an appraisal process is that no single performance appraisal method will be perfect for every organization.[6] Establishing an appropriate process involves significant planning and analysis in order to provide quality feedback to the employee. The most crucial task in the process is determining proper job dimensions that can be used to evaluate the employee against accepted standards that affect the performance of the team, business unit, or company.[7] Peter Drucker developed a method termed "Management by Objectives," or MBO, in order to address the need for specifying such job dimensions. Drucker suggests that objectives for any employee can be validated if they pass the following SMART test:[8]

- **S**pecific
- **M**easurable
- **A**chievable
- **R**ealistic
- **T**ime-related

The process of an evaluation typically includes one or more of the following:

- An assessment of how well the employee is doing. Sometimes this includes a scale rating indicating strengths and weaknesses in key areas (e.g., ability to follow instructions, complete work on time, and work with others effectively). It's also common for the supervisor and manager to discuss and determine the key areas.

- Employee goals with a deadline. Sometimes the employee may voluntarily offer a goal, while at other times it will be set by his or her boss. A significantly underperforming employee may be given a performance improvement plan, which details specific goals that must be met to keep the job.
- Feedback from coworkers and supervisors. The employee may also have the chance to share feelings, concerns, and suggestions about the workplace.
- Details about workplace standing, promotions, and pay raises. Sometimes an employee who has performed very well since the last review period may get an increase in pay or be promoted to a more prestigious position.

Methods of Performance Appraisal

Numerous methods exist for gauging an employee's performance, and each has strengths and weaknesses depending on the environment. The following outlines some of the more commonly used methods, as well as some recently developed ones that can be useful for various feedback situations:

- **Graphic rating scales:** This method involves assigning some form of rating system to pertinent traits. Ratings can be numerical ranges (1–5), descriptive categories (below average, average, above average), or scales between desirable and undesirable traits (poor ↔ excellent). This method can be simple to set up and easy to follow but is often criticized for being too subjective, leaving the evaluator to define broad traits such "leadership ability" or "conformance with standards."[9]
- **Behavioral methods:** A broad category encompassing several methods with similar attributes. These methods identify to what extent an employee displays certain behaviors, such as asking a customer to identify the usefulness of a sales representative's recommendation. While extremely useful for jobs where behavior is critical to success, identifying behaviors and standards for employees can often be very time-consuming for an organization.[10]
- **2+2:** A relative newcomer in performance appraisal methodology, the 2+2 feedback system demonstrates how appraisals can be used primarily for improvement purposes. By offering employees two compliments and two suggestions for improvement focused around high-priority areas, creators Douglas and Dwight Allen suggest that organizations can become "more pleasant, more dynamic, and more productive."[11] If the goal is employee improvement, this system can provide significant benefits; however, if the goals are compensation changes and rankings, the system provides little benefit.

Appraisal methodologies depend greatly on the type of work being done; an assembly worker will require a very different appraisal system from a business consultant. Significant planning will be required to develop appropriate methods for each business unit in an organization in order to obtain maximum performance towards the appraisal goals.

Compensation

Forms of Employee Financial Compensation

People talk about loving or hating their job, but do they ever mean that they love or hate how much compensation they receive for the job that they perform? Can someone pay you enough to take on jobs like Mike Rowe did on his television show, Dirty Jobs? How much an employee or manager is paid and the different ways that their compensation can be structured is an area in which HR managers find themselves competing with other employers. As the business environment become more complex, so do the forms of employee financial compensation. From a business standpoint, employee compensation can be thought of as the cost of acquiring human resources for running operations.

Salary

A salary is a form of compensation paid periodically by an employer to an employee, the amount and frequency of which may be specified in an employment contract. In general, employees paid a salary do not "punch a clock," and they work however many hours are necessary to accomplish organizational goals and objectives. Most managers are paid a salary that is calculated in terms of annual, monthly, or weekly earnings instead of hourly pay. U.S. employment law distinguishes between exempt (salaried) and nonexempt (hourly) workers. Employers can require exempt employees to work long hours without paying overtime.

Today, the idea of a salary continues to evolve as part of a system of all the combined rewards that employers offer to employees. Salary is coming to be seen as part of a "total rewards" system, which includes bonuses, incentive pay, commissions, benefits, perks, and various other tools that help employers link rewards to an employee's measured performance.

Something that has become increasingly common is to offer salaried employees options to purchase stock in the company. An employee stock option (ESO) is a call option on the common stock of a company, granted by the company to an employee as part of the employee's compensation package. The objective is to give employees an incentive to behave in ways that will boost the company's stock price. In many cases, the ESO represents an amount considerably higher than the employee's base salary. For example, in 2015 Satya Nadella, CEO of Microsoft, was paid a salary of $4.5 million, but his stock options earned him an additional $79.8 million.

Wage Systems

Wage payment systems offer another means by which organizations compensate employees. Unlike salary, wage systems are based on either hours worked or some other measure of production. Some of the most common wage systems are the following:

- **Time rate:** Under this system, a worker is paid by the hour for time worked. Time worked beyond a set amount (generally 40 hours per week) is paid as "overtime" and at a higher base hourly wage, usual 1 1/2 times higher.
- **Differential time rate:** According to this method, different hourly rates are fixed for different shifts or different assignments. The most common differential time rate occurs in production facilities where workers who are assigned to a graveyard shift (e.g., 11:00 p.m.–7:00 a.m.) are paid a "shift differential" that can range from a few cents to many dollars per hour.
- **Payment by piecework:** The worker's wages depends on his or her output and the rate of each unit of output; it is in fact independent of the time taken by the worker. In other words, for every "piece" a worker produces, he or she is paid a set amount. This type of pay has fallen out of favor with many businesses since it emphasizes quantity over quality. That said, today's "gig economy" relies on a kind of payment by piecework. According to Uber, the company's drivers are independent contractors, receiving payment for each trip.

Hybrid Wage Systems

Piecework system: A family in New York City making dolls' clothes by piecework in 1912. Each family member earns money based on how many pieces he or she produces.

Some employees' positions are structured in a way that doesn't fit with conventional salary or wage systems. In these cases, employers pay their employees by a "hybrid method." Hybrid wage systems are most common in sales positions or management positions. The most common hybrid wage

- **Straight Commission.** Under a straight commission system, the employee receives no compensation from their employer unless they close a sale or transaction. Real-estate agents and car sales staff are two of the best-known examples of professions in which straight commission is the standard form of compensation. One hundred percent of such employees' compensation is dependent upon selling the customer a product, good, or service. This approach to compensation has fallen out of favor in many businesses because it can lead to salespeople to make high-pressure sales—putting undue pressure on customers to buy something so the salesperson can get paid.
- **Salary plus commission.** Similar to the straight commission, salary plus commission requires an employee to make a sale or "close a deal" in order to earn compensation. However, only a portion of the employee's compensation is comes from the commission. The employer pays the employee some level of wages every pay period, regardless of his or her sales level. This reduces the necessity for high-pressure sales tactics, so long as the base salary is an adequate wage. Wait staff are essentially paid salary plus commission (they receive an hourly wage plus tips), but the hourly wage for such work can be as little as $2.10 per hour.
- **Salary plus bonus.** When an employee is paid a salary plus bonus, the bonus is not paid unless sales-volume or production goals are met or exceeded. For example, the manager of a real-estate firm may be paid a substantial salary but will earn a bonus only if the office he or she manages exceeds some pre-established sales figure for the month, quarter, or year. The advantage of a salary plus bonus is that it's tied to the performance of a department or division, thereby motivating the entire team to work together to reach organizational goals or sales targets.

Benefits

Compensation includes more than just salary, and benefits are a key legal, motivational, and organizational consideration when it comes to employee relations. Standard benefits address a range of employee needs, and they can be a key reason for employees to seek out employers who offer them. Human resource professionals must familiarize themselves with the various benefit options that are out there. The following lists the most common types of benefits:

- **Relocation assistance:** Often enough, hiring someone means moving the new employee to a different location. The talent an employer needs may come from another city or country, and attracting the right person may entail providing assistance with visas, housing, flights, and a range of other moving costs.
- **Medical, prescription, vision, and dental plans:** Particularly in countries with poor social benefits (such as the U.S.), medical insurance is a necessity for employers hiring full-time workers (sometimes it's even legally required). In countries with strong social welfare systems (such as Canada), these benefits are provided by the government.
- **Dependent care:** Many employees obtain health insurance coverage through their employer not only for themselves but for their spouse and/or children, too.
- **Retirement benefit plans (pension, 401(k), 403(b)):** Larger employers usually offer employees various retirement-related benefits such as long-term investments, pensions, and other savings for retirement. The primary draw for most of these benefits is the tax benefit (the ability to set aside pretax income for retirement savings).
- **Group term life and long-term care insurance plans:** Life insurance and long-term care are benefits paid by employers to insure individuals against various types of risks and disasters. Employees with life insurance or long-term care insurance will see their dependents (and themselves, in the case of long-term care) financially supported if a serious ailment or tragedy occurs.
- **Legal assistance plans:** Not quite as standard as the rest of the benefits above, legal assistance plans can be established for jobs in which personal liability is high. Legal assistance is expensive, and such plans draw on organizational resources to cover the employee under circumstances when legal aid is needed.
- **Child care benefits:** Supporting employees' families is absolutely critical to retaining great talent. Especially in families with two working parents, employer-covered child care is a key benefit that provides cost savings to the employee while enabling the employee to focus on work (which benefits the employer).
- **Transportation benefits:** Another common benefit is paid transportation. Particularly in countries/regions where public transportation is the norm, it's quite common for the employer to pay for all work-related transportation.
- **Paid time off (PTO) in the form of vacation and sick pay:** All organizations must provide paid time off, vacation, and sick pay under certain circumstances. Many countries have stringent legislation governing minimum requirements for paid time off and vacation leave to ensure that employees have a healthy work-life balance.

While there are other, less common benefits that employers can offer, the list above describes the standard benefits that employees can expect to encounter.

Fringe Benefits

One of the perks this lifeguard enjoys is the use of a company car.

The term *fringe benefits* was coined by the War Labor Board during World War II to describe the various indirect benefits that industry had devised to attract and retain labor when direct wage increases were prohibited. The term perks (from "perquisites") is often used colloquially to refer to those benefits of a more discretionary nature.

Perks are often given to employees who are doing notably well or have seniority. Common perks are hotel stays, free refreshments, leisure activities on work time, stationery, allowances for lunch, and take-home vehicles. When numerous options are available, certain employees may also be given first choice on such things as job assignments and vacation scheduling. They may also be given first chance at job promotions when vacancies exist.

Benefits may also include formal or informal employee discount programs that grant workers access to specialized offerings from local and regional vendors (e.g., movies and theme-park tickets, wellness programs, discounted shopping, hotels and resorts, and so on). Companies that offer these types of work-life perks seek to raise employee satisfaction, corporate loyalty, and worker retention by providing valued benefits that go beyond a base salary. Fringe benefits are thought of as the costs of keeping employees (besides, of course, salary).

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11. Formula 2+2, 2004 ↵

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15.6: Termination

What you'll learn to do: describe the different HR management options for employee termination

In this section you'll learn about the different options available to HR managers when they need to terminate employees.

Learning Objectives

- Describe the different HR management options for employee termination

Termination

Terminations can occur for a range of reasons, both voluntary and involuntary. The type of termination, however, determines the employee's future relationship with the employer (or lack thereof).

Being Fired

Being fired is usually thought to be the employee's fault and considered to be dishonorable and a sign of failure. It can hinder the job seeker's chances of finding new employment, particularly if the person has been fired from earlier jobs. Prospective employees don't always include jobs they were fired from on their résumés. As a result, employers may view unexplained gaps in employment or an applicant's refusal to provide references from previous employers as "red flags."

Being Laid Off

A less severe form of involuntary termination is often referred to as a layoff. Usually a layoff isn't strictly related to personal performance but is instead the result of economic cycles or the company's need to restructure itself, the firm itself going out of business, or a change in the function of the employer. In a postmodern risk economy, such as that of the United States, a large proportion of workers may be laid off at some point in their life for reasons other than job competence or performance.

Layoffs may occur as a result of downsizing (a reduction in the size of the workforce) or redundancy (the view that certain posts aren't needed). Such layoffs are not technically classified as firings; laid-off employees' positions are terminated and not refilled, because either the company wishes to reduce its size or operations or otherwise lacks the economic stability to retain the position. In some cases, laid-off employees may be offered back their old positions with the firm, though by that time they may have moved on to a new job.

Attrition

Some companies resort to attrition as a means of reducing their workforce. Under such a plan, the company doesn't force anyone to leave, but those who depart voluntarily are not replaced. Sometimes companies give workers the option to resign in exchange for a fixed amount of money, typically a few years of their salary. The U.S. Government under President Bill Clinton in the 1990s and the Ford Motor Company in 2005 have both followed the practice of attrition.

Mutual-Agreement Termination

Some terminations occur as a result of mutual agreement between the employer and employee. It may be a matter of debate as to whether such terminations are really mutual. In many of these cases, the employer wants the employee to quit but decides to offer a mutual-termination agreement in order to soften the firing (as in a forced resignation). There are also times when a termination date is agreed upon in an employment contract before the employment starts.

Forced Resignation

Firms that want an employee to leave of his or her own accord, but don't wish to pursue firing, may degrade the employee's working conditions, hoping that he or she will leave "voluntarily." The employee may be moved to a different geographical location, assigned to an undesirable shift, given too few hours if part time, demoted, or assigned to work in uncomfortable conditions. Companies may use other forms of manipulation to force an employee's resignation, often so they won't have to fill out termination papers in jurisdictions without at-will employment. (*At–will employment* is a term used in U.S. labor law for contractual relationships in which an employee can be dismissed by an employer without warning and for any reason—without having to establish "just cause" for termination.) In addition, with a few exceptions, employees who leave voluntarily usually cannot collect unemployment benefits. Such tactics may amount to constructive dismissal, which is illegal in some jurisdictions.

Rehire Following Termination

Depending on the circumstances, one whose employment has been terminated may or may not be able to be rehired by the same employer. If the decision to terminate was the employee's, the willingness of the employer to rehire is often contingent upon the relationship the employee had with the employer, the amount of notice given by the employee prior to departure, and the needs of the employer.

In some cases, when an employee departed on good terms, he or she may be given special priority by the employer when seeking rehire. An employee may be terminated *without prejudice*, meaning that the fired employee may be rehired readily for the same or a similar job in the future. This is usually true in the case of a layoff. Conversely, a person can be terminated *with prejudice*, meaning that an employer will not rehire the former employee to a similar job in the future. This judgment can be made for a number of reasons including incompetence, misconduct, insubordination, or attitude.

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15.7: HR Challenges

What you'll learn to do: discuss the challenges facing today's HR managers

Today's HR managers face special challenges, especially where employee turnover is concerned. In this section you'll learn how they can address this issues.

Learning Objectives

- Describe HR strategies for reducing employee turnover
- Summarize the challenges facing today's HR managers

Reducing Turnover

The following is a list of the top reasons why people change jobs:

- The downsizing or the restructuring of an organization (54 percent)
- New challenges or opportunities that arise (30 percent)
- Poor or ineffective leadership (25 percent)
- Having a poor relationship with a manager (22 percent)
- For better work-life balance (21 percent)
- Contributions are not being recognized (21 percent)
- For better compensation and benefits (18 percent)
- For better alignment with personal and organizational values (17 percent)
- Personal strengths and capabilities are not a good fit with an organization (16 percent)
- The financial instability of an organization (13 percent)
- An organization relocated (12 percent)

In a human resources context, **turnover** is the rate at which employees leave an organization. Simple ways to describe it are "how long employees tend to stay" or "the rate of traffic through the revolving door." Staff turnover can be optimal when a poorly performing employee decides to leave an organization or dysfunctional when the high turnover rate increases the costs associated with recruiting and training new employees or if good employees consistently decide to leave. Turnover is measured for individual companies and for industries as a whole. If an employer is said to have high turnover relative to its competitors, it means that employees of that company have a shorter average tenure than those of other companies in the same industry. High turnover may be harmful to a company's productivity if skilled workers are often leaving and the worker population contains a high percentage of novice workers.

Preventing the turnover of employees is important in any business. Without them, the business would be unsuccessful. However, according to the Bureau of Labor Statistics, more and more employers today are finding that employees remain for approximately 23 to 24 months. The Employment Policy Foundation reports that it costs a company an average of $15,000 per employee turnover, which includes separation costs such as paperwork and unemployment; vacancy costs, including overtime or temporary employees; and replacement costs including advertisement, interview time, relocation, training, and decreased productivity when colleagues depart.

Research on employee job turnover has attempted to understand the causes of individual decisions to leave an organization. It has been found that lower performance, lack of reward contingencies for performance, and better external job opportunities are the main causes. Other variables related to turnover are the conditions in the external job market, the availability of other job opportunities, and the length of employee tenure.

Providing a stimulating workplace environment, which fosters happy, motivated, and empowered individuals, lowers employee turnover and absentee rates. Creating a work environment that supports personal and professional growth promotes harmony and encouragement on all levels, so the effects are felt companywide.

Continual training and reinforcement also help to develop a workforce that is competent, consistent, competitive, effective, and efficient. Beginning on the first day of work, providing individuals with the necessary skills to perform their job is important. Before the first day, it is important for the interview and hiring process to expose new hires to the mission and culture of the company, so individuals know whether the job is a good fit and their best choice.

Networking and strategizing within the company provide ongoing performance management and help build relationships among coworkers. It is also important to motivate employees to focus on customer success, profitable growth, and the company well-being. Employers can keep their employees informed and involved by including them in future plans, new purchases, and policy changes, and by introducing new employees to the employees who have gone above and beyond in meetings. Engagement with employees—by sharing information with them or giving out recognition rewards—makes them feel included and shows them that they are valuable.

In addition, when organizations pay above-market wages, the worker's motivation to leave and look for a job elsewhere is be reduced. This strategy makes sense because it is often expensive to train replacement workers.

When companies hire the best people, newly hired talent and veterans are positioned to reach company goals, maximizing the investment of each employee. Taking the time to listen to employees and help them feel involved will create loyalty, which, in turn, can have a big impact on employee turnover.

HR Challenges

Ultimately, the role of an HR manager is maintaining the level of human capital needed by the business to meet its organizational goals. In working to meet the demands for a high-quality and dedicated workforce, HR managers must cope with challenges and trends that often lie beyond their control. How they react to and address these challenges can have a big effect on the success of the organization. The following is a summary of the major challenges facing human resource managers today.

Increased competition for qualified workers. As labor market conditions improve and economies expand, more companies are drawing from the same pool of skilled workers. Employees who possess skills sets that are in short supply find that they can have their pick of employers, and HR managers need to be ready to respond with benefits beyond salary, such as flexible working hours, employee-oriented working conditions, and long-term job security. The degree to which an organization is reputed to be a "great place to work" can affect the success of recruitment and retention efforts, as prospective employees now often rate employers on criteria such as CSR, intellectual-property policies, and environmental issues.

Changing demographics in the labor pool. With the aging of the baby-boom generation, older workers are expected to make up a much larger share of both the population and the labor force than in the past. The aging of the overall population has a significant impact on the labor pool and its growth. Populations age as a result of increases in life expectancy and/or a decrease in their fertility rates. According to the U.S. Census Bureau, the ratio of people 65 years and older to those between 20 and 64 years could **double** between now and the middle of the century. In addition, the ethnic and gender composition of the workforce is changing. Historical data and projections from the BLS shown in the table below highlight some of the trends in the demographics of the U.S. workforce.

Median age of the labor force, by gender, race, and ethnicity, 1992, 2002, 2012, and projected 2022

Group	1992	2002	2012	2022
Total	37.1	39.8	41.9	42.6
Men	37.2	39.8	41.8	42.2
Women	37.0	40.0	42.1	43.1
White	37.3	40.2	42.6	43.3
Black	35.5	38.1	39.7	40.3
Asian	36.2	38.8	40.9	42.9
Hispanic origin	32.5	34.0	36.9	38.9
White non-Hispanic	37.8	41.1	44.2	44.8
Source: U.S. Bureau of Labor Statistics.				

Increased globalization of economies. As countries enter into more and more global trade agreements such as the Trans Pacific Partnership (TPP), companies are finding it easier to go offshore and/or outsource key functions within the organization. When

processes go offshore, an entire division of a company may be relocated to another country, eliminating jobs in the U.S. permanently. For example, Hewlett Packard laid off five hundred employees working in customer service and technical support in Conway, Arkansas, when it moved the division to India. Many colleges now outsource their bookstore services to companies such as Barnes & Noble, thus eliminating the positions associated with managing and running the college bookstore. In such cases, it often falls to the HR manager to lay off the personnel in the departments whose responsibilities have been outsourced.

Workplace violence. While more and more information on the causes of workplace violence and ways of handling it is available, there is often no reasonable explanation for its occurrence, and, despite everything we know or do, violent situations happen. No employer is immune from workplace violence, and no employer can totally prevent it. Today's HR managers are tasked with informing employees about workplace violence policies and programs, investigating all acts of violence, threat, and similar disruptive behavior, and encouraging employees who show signs of stress or possible violence to seek counseling or help through employee assistance programs.

Employee turnover. In a human resources context, turnover is the rate at which employees leave an organization. Simple ways to describe it are "how long employees tend to stay" or "the rate of traffic through the revolving door." Staff turnover can be beneficial when a poorly performing employee decides to leave an organization or detrimental when the high turnover rate increases the costs associated with recruiting and training new employees or if good employees consistently decide to leave. High turnover can be harmful to a company's productivity if skilled workers are steadily leaving and the worker population contains a high percentage of novice workers. HR managers must constantly be on the lookout for ways of reducing employee turnover. As you'll recall, it costs a company, on average, $15,000 when it loses an employee.

Data-driven HR practices. The growing importance of "big data" presents human resource managers with an opportunity—and puts them under pressure. Business leaders are increasingly demanding that HR professionals, like their colleagues in other functional areas, use metrics and in-depth analysis to both make good decisions and demonstrate the return on investment of key expenditures.[1]

These are just a few of the emerging topics and trends that today's HR managers must handle, while still recruiting, hiring, and maintaining the organizations' existing workforce. As the world becomes increasingly complex, so do the roles and responsibilities of today's human resource professionals.

1. https://www.shrm.org/hr-today/news/hr-magazine/0316/pages/the-big-issues-facing-hr.aspx ↵

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15.8: Putting It Together- Human Resource Management

Synthesis

Since the 1900s, American society has evolved, and the working conditions of employees have improved dramatically. Workplace discrimination and inequities still exist, however, and human resource professionals play an important role in reducing and eliminating them. How can such efforts impact your work life?

If your position in a company gives you human resource management responsibilities, then it is essential that you understand the employer-employee relationship from both a legal and ethical perspective. Failure to properly apply laws, regulations, and policies in your management of the workforce can result in high turnover rates, grievances, and even worse—lawsuits. A discrimination lawsuit can potentially be a death blow to a company, displacing hundreds or thousands of workers and negatively impacting the economy.

If you are an employee, then it's crucial for you to understand your rights under employment law. Knowing and exercising your rights is important not only for your own protection but for the general progress of improving conditions, pay, and benefits for other workers. Human resource managers are skilled in these areas and are a resource for employees should they experience discrimination, unfair treatment, or unsafe working conditions.

Recall the nineteenth-century workers you read about at the start of this module—they didn't have a human resource manager to act as their advocate in the face of dismal and dangerous conditions. Today, the work environment for most employees is certainly better—not perfect, but better. Just how much has it improved? Take a few minutes to watch the following video to see just how far we've come.

Summary

Human Resource Management

Human resource managers are responsible for the activities needed to recruit, hire, train, develop, and retain a workforce that meets the requirements of the companies strategic human resource plan. At all levels within the organization, the process of hiring workers results from a process of job analysis, operational planning, and the careful crafting of job descriptions that set out clear requirements for job performance.

Human Resources and Laws

Federal and state legislation have been enacted to prevent discrimination, set minimum wages, establish maximum work hours, and set standards for health and safety. Laws such as the ADA, EEOC, and the Civil Rights Act combine to create a work environment that affords workers protection from discrimination and exploitation.

Recruitment and Hiring

HR professionals manage the recruitment process in order to identify the pool of qualified applicants. Both internal and external candidates are selected based on job specifications, which are the result of an analysis of the job/position.

Training, Development, and Rewards

Once employees are hired, the HR managers must manage the process by which employees are trained and compensated, and also evaluate their performance. Performance evaluations involve setting goals, completing a formal written evaluation, communicating the results to the employee, and then taking corrective action where needed. HR professionals also oversee employees' professional development.

Termination

Terminations can occur for a range of reasons, both voluntary and involuntary. Types of termination include layoffs, being fired, attrition, mutual-agreement termination, and forced resignation. Some states allow at-will employment, which means that an employee can be dismissed by an employer without warning and for any reason—without the employer having to establish "just cause" for termination.

Challenges in Human Resource Management

The future holds many challenges for HR Managers. An aging workforce, increased diversity, working from home, and advances in technology all create an environment that brings new challenges to human resources.

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CHAPTER OVERVIEW

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16.1: Why It Matters- Accounting and Finance

Why learn how to use accounting and financial principles to make informed decisions?

Billy Joel at the 2009 premiere of the Metropolitan Opera in New York City.

> *If you don't immediately recognize the face in the picture, you'd probably recognize his music.*
>
> *If you said this is Billy Joel, "The Piano Man," well done! In case you are unfamiliar with his accomplishments, read the following, from his Web site:*
>
> *"Billy Joel has had 33 Top 40 hits and 23 Grammy nominations since signing his first solo recording contract in 1972. In 1990, he was presented with a Grammy Legend Award. Inducted into the Songwriters Hall of Fame in 1992, Joel was presented with the Johnny Mercer Award, the organization's highest honor, in 2001. In 1999 he was inducted into the Rock & Roll Hall of Fame, and has received the Recording Industry Association of America Diamond Award, presented for albums that have sold over 10 million copies.*
>
> *In November, 2014, Billy Joel received The Library of Congress Gershwin Prize for Popular Song. In 2014 he also received the once-in-a-century ASCAP Centennial Award, presented to American music icons in recognition of their incomparable accomplishments in their respective music genres and beyond*[1]"

So, what is Billy Joel pop/rock icon and ex-husband of "Uptown Girl" and supermodel Christie Brinkley doing in the accounting module? Well, Joel apparently never took accounting or knew enough about its basic principles to be an *informed consumer* of his own financial information. How can we tell? Because if he had understood how to read an income statement or balance sheet, he might not have found himself on the verge of bankruptcy in 1989.

In 1989 Billy Joel filed a $90-million lawsuit against his former manager, Frank Weber, for mishandling his income and expenses. According to the court documents, just two of the charges were the following:

- Weber double-billed Joel for music videos, cheated him on expenses (including travel and accounting fees), and mortgaged Joel's copyrights for $15 million without disclosing it on Joel's financial statements.
- Weber caused phony financial statements to be issued to Joel, which painted an unrealistic picture of Joel's finances and the value of his investments and failed to reflect liabilities, guarantees, loans, and mortgages on the financial statements.

How was Joel supposed to have known this was happening and prevented it? How could understanding something about accounting have helped him? How can it help *you*?

In order to ask a question, you have to possess enough knowledge about a subject to know what to ask. Even understanding how to compare financial statements between multiple periods could have helped. Knowing what should have appeared on the various financial statements might have helped Joel spot gaps and missing information. Does that mean that understanding accounting protects you (or Billy Joel) from unethical business practices? Unfortunately, if someone is determined to act unethically, they'll probably find a way. Nonetheless, becoming an informed consumer of financial and accounting information can teach you what to look for, tip you off to irregularities, and reduce your likelihood of being a victim of others' financial dishonesty or mistakes. In short, there are many good reasons to study accounting even if you don't plan to be an accountant.

Throughout this module you will learn about key financial statements, financial ratios, measures of corporate financial health, and some of the ethical issues surrounding accounting practices. By the end, you might not be a rock star, but you'll be a more informed user of financial information—without learning the hard way!

1. http://www.billyjoel.com/biography ↵

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16.2: Accounting in Business

What you'll learn to do: define accounting, and explain its role as a form of business communication

How businesses express their financial health and stability is by presenting an "accounting" of all their financial transactions. In this section you will explore in depth what accounting is and the vital information it communicates about the business.

Learning Objectives

- Identify the users and uses of financial accounting
- Identify the users and uses of managerial accounting

What Is Accounting?

Why Do we Need Financial Information?

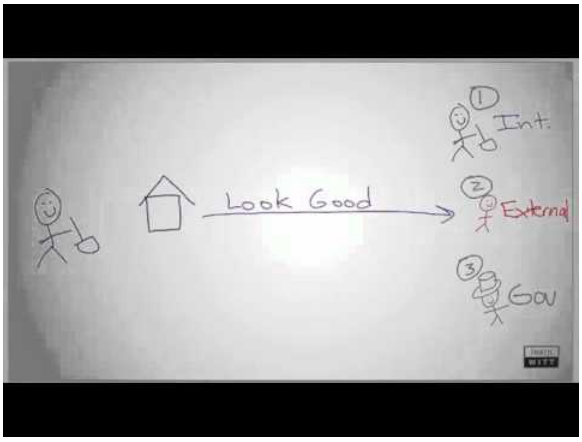
As you learned earlier in the course, businesses have large groups of stakeholders who have a vested interested in the continued success of the enterprise. If a business, whether for-profit or nonprofit, becomes financially insolvent and can't pay its bills, it will be forced to close. Financial information enables a business to track its accounts and avoid insolvency.

Each business needs financial information to be able to answer questions such as the following:

- How much cash does the business need to pay its bills and employees?
- Is the business profitable, earning more income than it pays in expenses, or is it losing money and possibly in danger of closing?
- How much of a particular product or mixture of products should the business produce and sell?
- What is the cost of making the goods or providing the service?
- What are the business's daily, monthly, and annual expenses?
- Do customers owe money to the business, and are they paying on time?
- How much money does the business owe to vendors (suppliers), banks, or other investors?

The video below gives a brief overview of many of the topics in this section. Before you review the video, consider these questions:

- What is accounting?
- What is business?
- Who are the three people that want to know the story of your business?
- What language of accounting does the government use?
- What language of accounting do investors use?
- What language of accounting do internal users employ?



Accounting Is the Language of Business

Every business organization that has economic resources, such as money, machinery, and buildings, uses accounting information. For this reason, accounting is called the language of business. Accounting also serves as the language providing financial information about not-for-profit organizations such as governments, churches, charities, fraternities, and hospitals. However, in this module we will focus on accounting for business firms.

The accounting process provides financial data for a broad range of individuals whose objectives in studying the data vary widely. Bank officials, for example, may study a company's financial statements to evaluate the company's ability to repay a loan. Prospective investors may compare accounting data from several companies to decide which company represents the best investment. Accounting also supplies management with significant financial data useful for decision making.

Definition of Accounting

As the video explained, accounting is "the language of business." The American Accounting Association defines **accounting** as "the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by the users of the information."

This information is primarily financial—stated in money terms. Accounting, then, is a measurement and communication process used to report on the activities of profit-seeking business organizations. As a measurement and communication process for business, accounting supplies information that permits informed judgments and decisions by users of the data.

Internal and External Users

Users of accounting information are separated into two groups, internal and external. **Internal users** are the people within a business organization who use accounting information. For example, the human resource department needs to have information about how profitable the business is in order to set salaries and benefits. Likewise, production managers need to know if the business is doing well enough to afford to replace worn-out machinery or pay overtime to production workers. **External users** are people outside the business entity that use accounting information. These external users include potential investors, the Internal Revenue Service, banks and finance companies, as well as local taxing authorities. Accounting information is valuable to both groups when it comes time to evaluate the financial consequences of various alternatives. Accountants reduce uncertainty by using professional judgment to quantify the future financial impact of taking action or delaying action. In short, although accounting information plays a significant role in reducing uncertainty within an organization, it also provides financial data for persons outside the company.

Financial accounting information appears in financial statements that are intended primarily for external use (although management also uses them for certain internal decisions). Stockholders and creditors are two of the outside parties who need financial accounting information. These outside parties decide on matters pertaining to the entire company, such as whether to increase or decrease their investment in a company or to extend credit to a company. Consequently, financial accounting information relates to the company as a whole, while managerial accounting focuses on the parts or segments of the company.

Because the external users of accounting information vary greatly, the way that financial information is presented must be consistent from year to year and company to company. In order to facilitate this, financial accountants adhere to set of rules called Generally Accepted Accounting Principles (GAAP). **GAAP** are a uniform set of accounting rules that allow users to compare the financial statements issued by one company to those of another company in the same industry. These principles for financial

reporting are issued by an independent non-profit agency created by the Securities Exchange Commission (SEC) called the **Financial Accounting Standards Board (FASB)**. The FASB's mission is "to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports."

Tax accounting information includes financial accounting information, written and presented in the tax code of the government—namely the Internal Revenue Code. Tax accounting focuses on compliance with the tax code and presenting the profit and loss story of a business to minimize its tax liability.

Accounting is more than just reporting income to taxing authorities or providing revenue and expense information to potential investors. As the language of business, accounting is used for decision-making as well.

Managerial accounting information is for internal use and provides special information for the managers of a company. The information managers use may range from broad, long-range planning data to detailed explanations of why actual costs varied from cost estimates. The employees of a firm who perform these managerial accounting functions are often referred to as Cost Accountants. Managerial accounting is more concerned with forward looking projections and making decisions that will affect the future of the organization, than in the historical recording and compliance aspects of the financial accountants. There are no reporting guidelines such as GAAP; therefore, managerial accounting reports will vary widely in both scope and content. Also, much of the information generated by managerial accountants is confidential and not intended to be shared outside of the organization. Managerial accounting focus on range of topics from production planning to budgets for raw materials. When a company makes a decision to purchase a component part instead of manufacture it in house, that decision is based primarily on managerial accounting information. For this reason, many managerial accountants consider themselves to be provide "accounting information for decision making."

Bookkeeping vs. Accounting

Accounting is often confused with bookkeeping. **Bookkeeping** is a mechanical process that records the routine economic activities of a business. **Accounting** includes bookkeeping, but it goes further to analyze and interpret financial information, prepare financial statements, conduct audits, design accounting systems, prepare special business and financial studies, prepare forecasts and budgets, and provide tax services.

Importance of Accounting

You probably will find that of all the business knowledge you have acquired or will learn, the study of accounting will be the most useful. Your financial and economic decisions as a student and consumer involve accounting information. When you file income tax returns, accounting information helps determine your taxes payable.

Understanding the discipline of accounting also can influence many of your future professional decisions. You cannot escape the effects of accounting information on your personal and professional life.

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16.3: Key Financial Statements

What you'll learn to do: identify key financial statements and their components, and explain the primary use of each type of statement

In this section you will learn about key financial statements of accounting: the balance sheet, income statement, statement of owner's equity, and statement of cash flows. By examining the components of each you will see the connections between the statements and be able to use this information to help you determine the point at which your business becomes profitable—the break-even point.

Learning Objectives

- Identify the use and components of the balance sheet
- Identify the use and components of the statement of owner's equity
- Explain how the balance sheet, income statement, statement of owner's equity, and statement of cash flows are connected

Financial Statements

Financial statements are the means by which companies communicate their story. Together these statements represent the profitability and financial strength of a company. The financial statement that reflects a company's profitability is the **income statement.** The **statement of owner's equity**—also called the **statement of retained earnings**—shows the change in retained earnings between the beginning and end of a period (e.g., a month or a year). The **balance sheet** reflects a company's solvency and financial position. The **statement of cash flows** shows the cash inflows and outflows for a company during a period of time.

Financial statements are summative reports in that they report information obtained from the day-to-day bookkeeping activities of financial accountants or bookkeepers. After all of the income and expenses of the business have been recorded, financial accountants prepare financial statements in the following order:

1. Income Statement
2. Statement of Retained Earnings—also called Statement of Owner's Equity
3. The Balance Sheet
4. The Statement of Cash Flows

The following video summarizes the four financial statements required by GAAP.

In order to get a better understanding of financial statements, what they communicate to the users of accounting information, and how the statements are connected, we will use the final balances as of January 31, 20XX for a fictitious delivery-service company, Metro Courier Inc. Just as a financial accountant would do, we will use these figures to prepare the company's financial statements required by GAAP.

Before we start, we need to define three terms and an equation that are used throughout the accounting process.

- **Asset**: An asset is an economic resource. Anything tangible or intangible that can be owned or controlled to produce value and that is held to have positive economic value is considered an asset. Simply stated, assets represent value of ownership that can be converted into cash (although cash itself is also considered an asset). Assets include things like cash, vehicles, buildings, equipment, patents, and debts owed to the company.
- **Liability**: A liability is defined as the future sacrifices of economic benefits that the entity is *obliged* to make to other entities as a result of past transactions or other *past* events, the settlement of which may result in the transfer or use of assets, provision of services, or other yielding of economic benefits in the future. Liabilities include things like loans, monies owed to suppliers or creditors that the business will use assets (i.e., cash) to settle.
- **Equity**: Equity is the difference between the value of the assets and the amount of the liabilities of something owned. Owner's equity consists of the net assets of an entity. Net assets is the difference between the total assets and total liabilities. When the owners are shareholders, the interest can be called shareholders' equity; the accounting remains the same, and it is ownership equity spread out among shareholders.

You can see that these three terms are interconnected, and their interconnection produces an equation that is at the heart of all financial accounting: **The Accounting Equation**. The accounting equation represents the relationship between assets, liabilities, and the owner's equity of a business. It's the foundation for the double-entry accounting system, accepted to be the most reliable and accurate method of recording the financial transactions of a business. The accounting equation must always "balance": The left and right side of the equation must be equal. The accounting equation is as follows:

Assets − Liabilities = Owner's or Shareholders' Equity

Now that you have a better understanding of the language of financial statements, let's look at Metro Courier's financial information and prepare some financial statements.

Balance of Accounts for Metro Courier Inc. as of January 31, 20XX

Cash	Asset	$ 66,800
Accounts Receivable	Asset	$ 5,000
Supplies	Asset	$ 500
Prepaid rent	Asset	$ 1,800
Equipment	Asset	$ 5,500
Truck	Asset	$ 8,500
Accounts Payable	Liability	$ 200
Common Stock	Equity	$ 30,000
Retained Earnings	Equity	$ 0
Service Revenue	Revenue	$ 60,000
Salary Expense	Expense	$ 900
Utilities Expense	Expense	$ 1,200

Income Statement

The **income statement,** sometimes called an earnings statement or profit and loss statement, reports the profitability of a business organization for a *stated period of time*. In accounting, we measure profitability for a period, such as a month or year, by comparing

the revenues earned with the expenses incurred to produce these revenues. This is the *first* financial statement prepared, as you will need the information from this statement for the remaining statements. The income statement contains the following:

- **Revenues** are the inflows of cash resulting from the sale of products or the rendering of services to customers. We measure revenues by the prices agreed on in the exchanges in which a business delivers goods or renders services.
- **Expenses** are the costs incurred to produce revenues. Expenses are costs of doing business (typically identified as accounts ending in the word "expense").
- **Revenues – Expenses = Net Income**. Net income is often called the earnings of the company. When expenses exceed revenues, the business has a **net loss**.

Metro Courier Inc.		
Income Statement		
Month Ended January 31, 20XX		
Revenue:		
Service Revenue	$ 60,000	
Total Revenues		$ 60,000
Expenses:		
Salary Expense	900	
Utility Expense	1, 200	
Total Expenses		2,100
Net Income ($60,000 – 2,100)		**$ 57,900**

The net income from the income statement will be used in the Statement of Equity.

Statement of Retained Earnings (or Owner's Equity)

The **statement of retained earnings**, explains the changes in retained earnings between two balance sheet dates. We start with beginning retained earnings (in our example, the business began in January, so we start with a zero balance) and add any net income (or subtract net loss) from the income statement. Next, we subtract any dividends declared (or any owner withdrawals in a partnership or sole-proprietor) to get the ending balance in retained earnings (or capital for non-corporations)

Metro Courier Inc.	
Statement of Retained Earnings	
Month Ended January 31, 20XX	
Beginning Retained Earnings, Jan 1	$ 0
Net income from month (from income statement)	57,900
Total increase	$ 57,900
Dividends (or withdrawals for non-corporations)	– $0
Ending Retained Earnings, January 31	**$ 57,900**

The ending balance we calculated for retained earnings (or capital) is reported on the balance sheet.

Balance Sheet

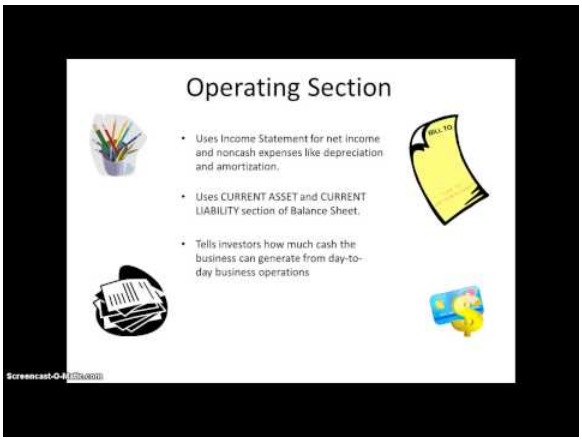
The **balance sheet** lists the company's assets, liabilities, and equity (including dollar amounts) as of a specific moment in time. That specific moment is the close of business on the date of the balance sheet. Notice how the heading of the balance sheet differs from the headings on the income statement and statement of retained earnings. A balance sheet is like a photograph; it captures the financial position of a company at a particular *moment* in time. The other two statements are for a *period* of time. As you learn about the assets, liabilities, and stockholders' equity contained in a balance sheet, you will understand why this financial statement provides information about the solvency of the business.

Metro Courier Inc.				
Balance Sheet				
January 31, 20XX				
Assets		**Liabilities and Equity**		
Cash	$ 66,800	Accounts Payable	200	
Accounts Receivable	5,000	**Total Liabilities**		200
Supplies	500			
Prepaid Rent	1,800	Common Stock	30,000	
Equipment	5,500	Retained Earnings	57,900	
Truck	8,500	**Total Equity**		87,900
Total Assets	**$ 88,100**	**Total Liabilities + Equity**		**$ 88,100**

You can see the accounting equation in action here on the balance sheet. The accounting equation is Assets – Liabilities = Owner's Equity. For Metro Courier Inc., this is $88,100 – $200 = $87,900.

Statement of Cash Flows

The main purpose of the statement of cash flows is to report on the cash receipts and cash disbursements of an entity during an accounting period. Broadly defined, cash includes both cash and cash equivalents, such as short-term investments in Treasury bills, commercial paper, and money market funds. Another purpose of this statement is to report on the entity's investing and financing activities for the period. The statement of cash flows reports the effects on cash during a period of a company's operating, investing, and financing activities. Firms show the effects of significant investing and financing activities that do not affect cash in a schedule separate from the statement of cash flows.



The **statement of cash flows** summarizes the effects on cash of the operating, investing, and financing activities of a company during an accounting period; it reports on past management decisions on such matters as issuance of capital stock or the sale of long-term bonds. This information is available only in bits and pieces from the other financial statements. Since cash flows are vital

to a company's financial health, the statement of cash flows provides useful information to management, investors, creditors, and other interested parties.

The statement of cash flows presents the effects on cash of all significant operating, investing, and financing activities. By reviewing the statement, management can see the effects of its past major policy decisions in quantitative form. The statement may show a flow of cash from operating activities large enough to finance all projected capital needs internally rather than having to incur long-term debt or issue additional stock. Alternatively, if the company has been experiencing cash shortages, management can use the statement to determine why such shortages are occurring. Using the statement of cash flows, management may also recommend to the board of directors a reduction in dividends to conserve cash.

The statement of cash flows classifies cash receipts and disbursements as operating, investing, and financing cash flows. Both inflows and outflows are included within each category.

Operating activities generally include the cash effects (inflows and outflows) of transactions and other events that enter into the determination of net income. Cash inflows from operating activities affect items that appear on the income statement and include: (1) cash receipts from sales of goods or services; (2) interest received from making loans; (3) dividends received from investments in equity securities; (4) cash received from the sale of trading securities; and (5) other cash receipts that do not arise from transactions defined as investing or financing activities, such as amounts received to settle lawsuits, proceeds of certain insurance settlements, and cash refunds from suppliers.

Cash outflows for operating activities affect items that appear on the income statement and include payments: (1) to acquire inventory; (2) to other suppliers and employees for other goods or services; (3) to lenders and other creditors for interest; (4) for purchases of trading securities; and (5) all other cash payments that do not arise from transactions defined as investing or financing activities, such as taxes and payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

Investing activities generally include transactions involving the acquisition or disposal of noncurrent assets. Thus, cash inflows from investing activities include cash received from: (1) the sale of property, plant, and equipment; (2) the sale of available-for-sale and held-to-maturity securities; and (3) the collection of long-term loans made to others. Cash outflows for investing activities include cash paid: (1) to purchase property, plant, and equipment; (2) to purchase available-for-sale and held-to-maturity securities; and (3) to make long-term loans to others.

Financing activities generally include the cash effects (inflows and outflows) of transactions and other events involving creditors and owners. Cash inflows from financing activities include cash received from issuing capital stock and bonds, mortgages, and notes, and from other short- or long-term borrowing. Cash outflows for financing activities include payments of cash dividends or other distributions to owners (including cash paid to purchase treasury stock) and repayments of amounts borrowed. Payment of interest is not included because interest expense appears on the income statement and is, therefore, included in operating activities. Cash payments to settle accounts payable, wages payable, and income taxes payable are not financing activities. These payments are included in the operating activities section.

Information about all material investing and financing activities of an enterprise that do not result in cash receipts or disbursements during the period appear in a separate schedule, rather than in the statement of cash flows. The disclosure may be in narrative form. For instance, assume a company issued a mortgage note to acquire land and buildings.

Financial Statements: Interconnectivity

Watch the following video, and pay special attention to the interconnection between the four financial statements required by GAAP.

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16.4: The Break-Even Point

What you'll learn to do: calculate the break-even point, where profit will be equal to $0, using information from financial statements

In this section you will learn to calculate the point where the amount of income you earn results in neither a profit nor a loss—and "breaks even."

Learning Objectives

- Differentiate between fixed and variable costs
- Calculate the contribution margin
- Calculate the margin of safety

Finding the Break-Even Point

When can you say a business is good or not? Watch the following video to find out.

The Break-Even Point

A company breaks even for a given period when sales revenue and costs incurred during that period are equal. Thus the **break-even point** is that level of operations at which a company realizes no net income or loss.

A company may express a break-even point in dollars of sales revenue or number of units produced or sold. No matter how a company expresses its break-even point, it is still the point of zero income or loss.

In order to grasp the concept of breakeven, it's important to understand that all costs are not created equal: Some are fixed, and some are variable. **Fixed Costs** are expenses that are not dependent on the amount of goods or services produced by the business. They are things such as salaries or rents paid per month. If you own a car, then your car payment and insurance premiums are fixed costs because you pay them every month whether you drive your car or not. **Variable Costs** are volume related and are paid per quantity or unit produced. For your car, your variable costs are things like gas, maintenance, or tires because you only incur these costs when you drive your car. The more miles you drive, the more your gas expenses go up—such costs vary with the level of activity.

Before we turn to the calculation of the break-even point, it's also important to understand contribution margin.

Contribution Margin

Contribution margin is the portion of revenue that is not consumed by variable cost. In a simple example, if you were to buy a candy bar for 75 cents and resell it for $1, then the contribution margin would be 25 cents—the amount not consumed by cost.

Of course, in business this is generally more complicated. It requires you to understand the variable costs for an item, or those costs that are directly tied to producing a new unit. When selling lemonade from a stand, the costs of the water, lemon juice, sweetener, ice, and serving glass are all variable costs that will recur with each item sold. The cost of the stand is a fixed cost. The labor required to make and serve the lemonade is also generally a fixed cost, as it doesn't vary based on the number of glasses sold. Let's look at this in numeric terms, as follows:

Inputs	Cost	Category
Lemons, sweetener, ice, and water	20 cents per glass	Variable
Glasses	5 cents each	Variable
Labor	$100 per day per employee	Fixed

Inputs	Cost	Category
Lemonade stand rental	$2,000 per month	Fixed

If we know that the stand sells 1,000 glasses of lemonade each day at $3 per glass, and that one employee can make and serve 1,000 glasses, then we can calculate the contribution margin.

The cost of raw materials is 25 cents per glass (20 for ingredients + 5 for the glass). If the lemonade is sold for $3 per glass, then the contribution margin is $2.75 per glass.

It's important to know the contribution margin in order to calculate what portion of the revenue from a product is consumed by the variable costs and what portion can be used to cover, or contribute to, fixed costs.

Breakeven in Units

To illustrate the calculation of a break-even point in units, Video Productions produces videotapes selling for USD 20 per unit. Fixed costs per period total USD 40,000, while the variable cost is USD 12 per unit.

We compute the break-even point in units by dividing total fixed costs by the contribution margin per unit. The contribution margin per unit is USD 8 (USD 20 selling price per unit – USD 12 variable cost per unit). In the following break-even equation, BE refers to the break-even point:

$$BE\,units = \frac{Fixed\ costs}{Contribution\ margin\ per\ unit}$$

$$BE\,units = \frac{USD\ 40{,}000}{8\ per\ unit}$$

$$BE\,units = 5{,}000\,units$$

The result tells us that Video Productions breaks even at a volume of 5,000 units per month. We can prove that to be true by computing the revenue and total costs at a volume of 5,000 units. Revenue = 5,000 units X USD 20 sales price per unit = USD 100,000. Total costs = USD 100,000 = USD 40,000 fixed costs + USD 60,000 variable costs (USD 60,000 = USD 12 per unit X 5,000 units).

Note that the revenue and total cost lines cross at 5,000 units—the break-even point. Video Productions has net income at volumes greater than 5,000, but it has losses at volumes less than 5,000 units.

Breakeven in Sales Dollars

Companies frequently measure volume in terms of sales dollars instead of units. For a company such as General Motors that makes not only automobiles but also small components sold to other manufacturers and industries, it makes no sense to think of a break-even point in units. General Motors evaluates breakeven in sales dollars.

The formula to compute the break-even point in sales dollars looks a lot like the formula to compute the breakeven in units, except we divide fixed costs by the contribution margin ratio instead of the contribution margin per unit.

$$BE\,units = \frac{Fixed\ costs}{Contribution\ margin\ ration}$$

A Broader Perspective: Even Colleges Use Breakeven

The dean of the business school at a particular university was considering whether to offer a seminar for executives. The tuition would be USD 650 per person. Variable costs, including meals, parking, and materials, would be USD 80 per person. Certain costs of offering the seminar, including advertising, instructors' fees, room rent, and audiovisual equipment rent, would not be affected by the number of people attending. Such seminar costs, which could be thought of as fixed costs, amounted to USD 8,000.

In addition to these costs, a number of staff, including the dean, would work on the program. Although the salaries paid to these staff were not affected by offering the seminar, working on it took these people away from other duties, thus creating an opportunity cost, estimated to be USD 7,000 for this seminar.

Given this information, the school estimated the break-even point to be (USD 8,000 + USD 7,000)/(USD 650 – USD 80) = 26.3 students. If the school wanted at least to break even on this program, it should offer the program only if it expected at least 27 students to attend.

Contribution Margin Ratio

The contribution margin ratio expresses the contribution margin as a percentage of sales. To calculate this ratio, divide the contribution margin per unit by the selling price per unit, or total contribution margin by total revenues. Video Production's contribution margin ratio is:

$$Contribution\,margin\,ratio = \frac{Contribution\ margin\ per\ unit}{Selling\ price\ per\ unit}$$

$$\frac{USD\ 20 - USD\ 12}{USD\ 20} = \frac{USD\ 8}{USD\ 20} = 0.40$$

Supposing that Video Productions had a total contribution margin of USD 48,000 on revenues of USD 120,000, we compute the contribution margin ratio as follows:

$$Contribution\,margin\,ratio = \frac{Total\ contribution\ margin}{Total\ revenues}$$

$$\frac{USD\ 48{,}000}{USD\ 120{,}000} = 0.40$$

That is, for each dollar of sales, there is a USD 0.40 contribution to covering fixed costs and generating net income.

Using this ratio, we calculate Video Production's break-even point in sales dollars as:

$$BE\,units = \frac{Fixed\ costs}{Contribution\ margin\ rate}$$

$$BE\,dollars = \frac{USD\,40{,}000}{0.40} = USD\,100{,}000$$

The break-even volume of sales is USD 100,000 (5,000 units at USD 20 per unit). At this level of sales, fixed costs plus variable costs equal sales revenue.

In a period of complete idleness (no units produced), Video Productions would lose USD 40,000 (the amount of fixed costs). However, when Video Productions has an output of 10,000 units, the company has net income of USD 40,000.

Although you are likely to use break-even analysis for a single product, you will more frequently use it in multi-product situations. The easiest way to use break-even analysis for a multi-product company is to use dollars of sales as the volume measure. For break-even analysis purposes, a multi-product company must assume a given product mix. **Product mix** refers to the proportion of the company's total sales attributable to each type of product sold.

To illustrate the computation of the break-even point for Wonderfood, a multi-product company that makes three types of cereal, assume the following historical data:

Product								
	1		2		3		Total	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Sales	$60,000	100%	$30,000	100%	$10,000	100%	$100,000	100%
Less:								
Variable costs	40,000	67%	16,000	53%	4,000	40%	60,000	60%
Contribution margin	$20,000	33%	$14,000	47%	$ 6,000	60%	$ 40,000	40%

We use the data in the total columns to compute the break-even point. The contribution margin ratio is 40 percent or (USD 40,000/USD 100,000). Assuming the product mix remains constant and fixed costs for the company are USD 50,000, break-even sales are USD 125,000, computed as follows:

$$BE\,units = \frac{Fixed\,costs}{Contribution\,margin\,ratio}$$

$$BE\,dollars = \frac{USD\,50{,}000}{0.40} = USD\,125{,}000$$

[To check our answer: (USD 125,000 X 0.40) – USD 50,000 = USD 0.]

To find the three product sales totals, we multiply total sales dollars by the percent of product mix for each of the three products. The product mix for products 1, 2, and 3 is 60:30:10, respectively. That is, out of the USD 100,000 total sales, there were sales of USD 60,000 for product 1, USD 30,000 for product 2, and USD 10,000 for product 3. Therefore, the company has to sell USD 75,000 of product 1 (0.6 X USD 125,000), USD 37,500 of product 2 (0.3 X USD 125,000), and USD 12,500 of product 3 (0.1 X USD 125,000) to break even.

an accounting perspective: business insight

The founder of Domino's Pizza, Inc. nearly went bankrupt several times before he finally made Domino's a financial success. One early problem was that the company was providing small pizzas that cost almost as much to make and just as much to deliver as larger pizzas. Because they were small, the company could not charge enough to cover its costs. At one point, the company's founder was so busy producing small pizzas that he did not have time to determine that the company was losing money on them.

Margin of Safety

If a company's current sales are more than its break-even point, it has a margin of safety equal to current sales minus break-even sales. The **margin of safety** is the amount by which sales can decrease before the company incurs a loss. For example, assume Video Productions currently has sales of USD 120,000 and its break-even sales are USD 100,000. The margin of safety is USD 20,000, computed as follows:

Margin safety = Current sales – Break-even sales

= USD 120,000 – USD 100,000

= USD 20,000

Sometimes people express the margin of safety as a percentage, called the margin of safety rate. The **margin of safety rate** is equal to $\frac{Current\,sales - Break\text{–}even\,sales}{Current\,sales}$. Using the data just presented, we compute the margin of safety rate as follows:

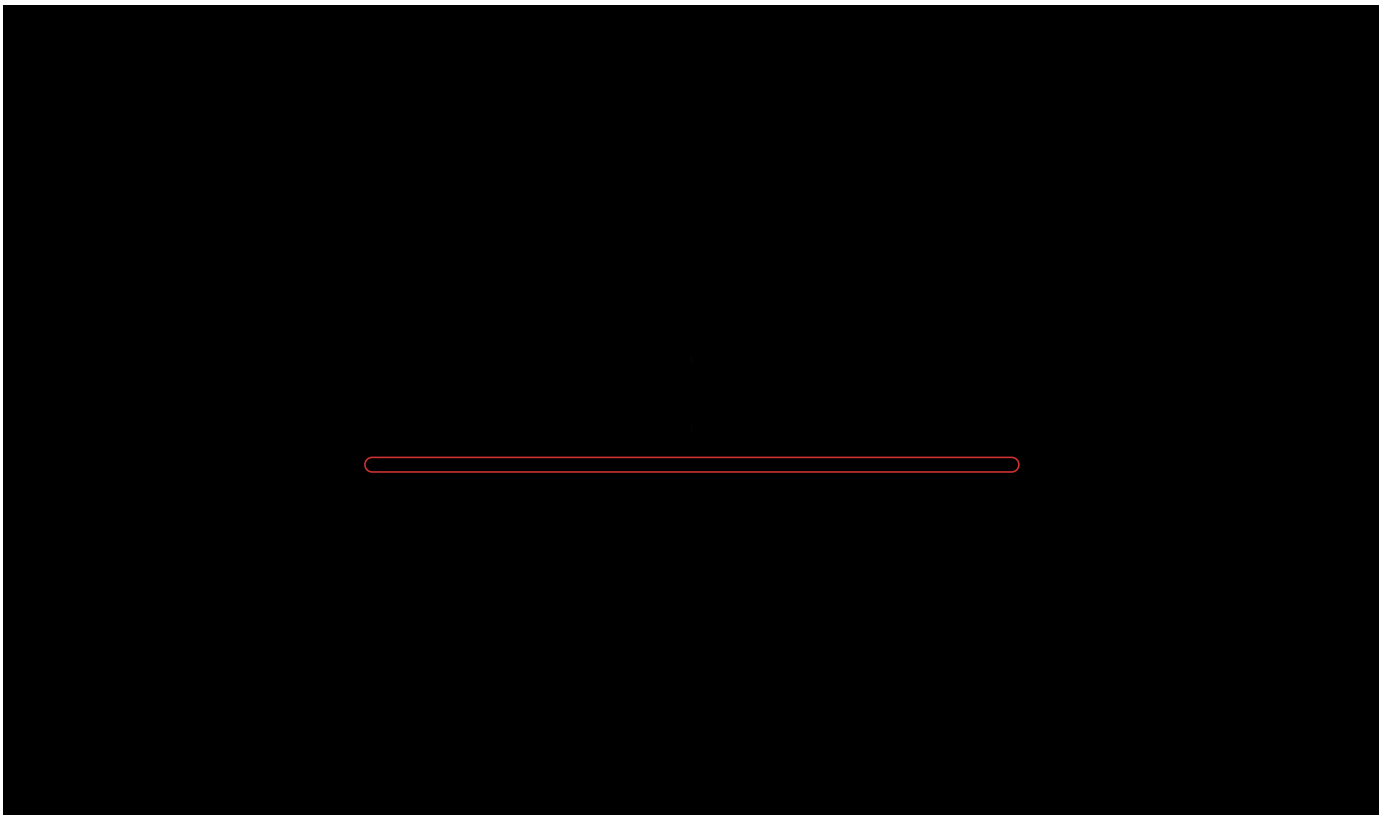
$$Margin\,of\,safety\,rate = \frac{Current\,sales - Break\text{–}even\,sales}{Current\,sales}$$

$$\frac{USD\,120{,}000 - USD\,100{,}000}{USD\,12{,}000} = 16.67\%$$

This means that sales volume could drop by 16.67 percent before the company would incur a loss.

Try It

Play the simulation below multiple times to see how different choices lead to different outcomes. All simulations allow unlimited attempts so that you can gain experience applying the concepts.



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16.5: Financial Ratios

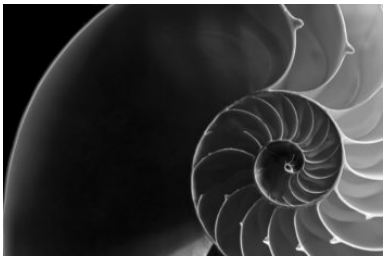
What you'll learn to do: use financial statements to calculate basic financial ratios to measure the profitability and health of a business

Financial ratios allow consumers of financial information to compare how companies are doing relative to their industry or even how they are faring from one period (month, quarter, year) to another. For the purposes of this course, you will be working with just a couple of these ratios—namely liquidity and profitability. There are lots of other financial ratios, but you can save those for a time when you take full courses in finance and accounting.

Learning Objectives

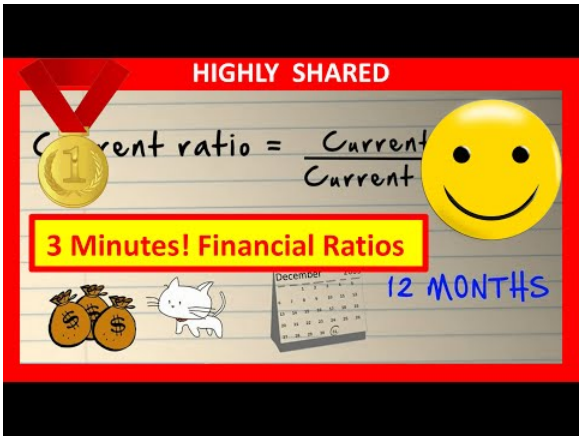
- Calculate the current ratio using information from financial statements
- Calculate inventory turnover using information from financial statements

Financial Ratio Analysis



Financial ratios allow us to look at profitability, use of assets, inventories, and other assets, liabilities, and costs associated with the finances of the business. We can also use them to learn how quickly people pay their bills, how long it takes the company to recover its costs for new equipment, how much cash the company has relative to its debt, and its return (profit) on every dollar the company invests. Financial ratios also enable a company to compare itself to other firms in the same industry and answer questions like "Are the other dog biscuit companies doing about the same as ours?"

Sometimes it's not enough to say that a company is in good or bad financial health, especially if you're trying to compare that company with another one. To make comparisons easier, it helps to assign numbers to "health." The following video explains how that can be done.



Logical relationships exist between certain accounts or items in a company's financial statements. These accounts may appear on the same statement or on two different statements. We set up the dollar amounts of the related accounts or items in fraction form called ratios. These ratios include the following:

Ratio	Use	Components
Liquidity ratio	indicate a company's short-term debt-paying ability	**current (or working capital) ratio; acid-test (quick) ratio;** cash flow liquidity ratio; accounts receivable turnover; number of day's sales in accounts receivable; **inventory turnover**; and total assets turnover
Equity (long-term solvency) ratio	show the relationship between debt and equity financing in a company	equity (or stockholders' equity) ratio; and stockholders' equity to debt ratio
Profitability test	an important measure of a company's operating success	rate of return on operating assets; net income to net sales; net income to average common stockholders' equity; cash flow margin; earnings per share of common stock; times interest earned ratio; and times preferred dividends earned ratio
Market test	help investors and potential investors assess the relative merits of the various stocks in the marketplace	earnings yield on common stock; price-earnings ratio; dividend yield on common stock; payout ratio on common stock; dividend yield on preferred stock; and cash flow per share of common stock

Many of these ratios are beyond the scope of this course; however, we will examine the ones in bold, above, which are key to evaluating any business.

Current (or Working Capital) Ratio

Working capital is the excess of current assets over current liabilities. The ratio that relates current assets to current liabilities is the **current (or working capital) ratio**. The current ratio indicates the ability of a company to pay its current liabilities from current assets, and thus shows the strength of the company's working capital position.

You can compute the current ratio by dividing current assets by current liabilities, as follows:

$$Current\ ratio = \frac{Current\ assets}{Current\ liabilities}$$

The ratio is usually stated as a number of dollars of current assets to one dollar of current liabilities (although the dollar signs usually are omitted). Thus, for Synotech in 2010, when current assets totaled USD 2,846.7 million and current liabilities totaled USD 2,285.2 million, the ratio is 1.25:1, meaning that the company has USD 1.25 of current assets for each USD 1.00 of current liabilities.

The current ratio provides a better index of a company's ability to pay current debts than does the absolute amount of working capital. To illustrate, assume that we are comparing Synotech to Company B. For this example, use the following totals for current assets and current liabilities:

	Synotech	**Company B**
Current assets (a)	$ 2,846.7	$120.0
Current liabilities (b)	2,285.2	53.2
Working capital (a – b)	$ 561.5	$ 66.8
Current ratio (a/b)	1.25:1	2.26:1

Synotech has eight times as much working capital as Company B. However, Company B has a superior debt-paying ability since it has USD 2.26 of current assets for each USD 1.00 of current liabilities.

Short-term creditors are particularly interested in the current ratio since the conversion of inventories and accounts receivable into cash is the primary source from which the company obtains the cash to pay short-term creditors. Long-term creditors are also interested in the current ratio because a company that is unable to pay short-term debts may be forced into bankruptcy. For this reason, many bond indentures, or contracts, contain a provision requiring that the borrower maintain at least a certain minimum current ratio. A company can increase its current ratio by issuing long-term debt or capital stock or by selling noncurrent assets.

A company must guard against a current ratio that is too high, especially if caused by idle cash, slow-paying customers, and/or slow-moving inventory. Decreased net income can result when too much capital that could be used profitably elsewhere is tied up in current assets.

Acid-Test (Quick) Ratio

The current ratio is not the only measure of a company's short-term debt-paying ability. Another measure, called the **acid-test (quick) ratio**, is the ratio of quick assets (cash, marketable securities, and net receivables) to current liabilities. The formula for the acid-test ratio is the following:

$$Acid\,test\,ratio = \frac{Quick\,assets}{Current\,liabilities}$$

Short-term creditors are particularly interested in this ratio, which relates the pool of cash and immediate cash inflows to immediate cash outflows.

The acid-test ratios for 2010 and 2009 for Synotech follow:

	December 31		
(USD millions)	**2010**	**2009**	**Amount of increase or (decrease)**
Quick assets (a)	$1,646.6	$1,648.3	$ (1.7)
Current liabilities (b)	2,285.6	2,103.8	181.8
Net quick assets (a – b)	$ (639.0)	$ (455.5)	$(183.5)
Acid-test ratio (a/b)	.72:1	.78:1	

In deciding whether the acid-test ratio is satisfactory, investors consider the quality of the marketable securities and receivables. An accumulation of poor-quality marketable securities or receivables, or both, could cause an acid-test ratio to appear deceptively favorable. When referring to marketable securities, poor quality means securities likely to generate losses when sold. Poor-quality receivables may be uncollectible or not collectible until long past due. The quality of receivables depends primarily on their age, which can be assessed by preparing an aging schedule or by calculating the accounts receivable turnover.

Inventory Turnover

A company's inventory turnover ratio shows the number of times its average inventory is sold during a period. You can calculate **inventory turnover** as follows:

$$Inventory\,turnover = \frac{Cost\,of\,goods\,sold}{Average\,inventory}$$

When comparing an income statement item and a balance sheet item, we measure both in comparable dollars. Notice that we measure the numerator and denominator in cost rather than sales dollars. Inventory turnover relates a measure of sales volume to the average amount of goods on hand to produce this sales volume.

Synotech's inventory on 2009 January 1, was USD 856.7 million. The following schedule shows that the inventory turnover decreased slightly from 5.85 times per year in 2009 to 5.76 times per year in 2010. To convert these turnover ratios to the number of days it takes the company to sell its entire stock of inventory, divide 365 by the inventory turnover. Synotech's average inventory sold in about 63 and 62 (365/5.76 and 365/5.85) in 2010 and 2009, respectively.

	December 31		
(USD millions)	**2010**	**2009**	**Amount of increase or (decrease)**
Cost of goods sold (a)	$5,341.3	$5,223.7	$117.6
Merchandise inventory:			
January 1	$929.8	$856.7	$ 73.1
December 31	924.8	929.8	(5.0)
Total (b)	$1,854.6	$1,786.5	$ 68.1
Average inventory (c) (b/2 = c)	$927.3	$893.3	

Turnover of inventory (a/c)	5.76	5.85

Other things being equal, a manager who maintains the *highest* inventory turnover ratio is the most efficient. Yet, other things are not always equal. For example, a company that achieves a high inventory turnover ratio by keeping extremely small inventories on hand may incur larger ordering costs, lose quantity discounts, and lose sales due to lack of adequate inventory. In attempting to earn satisfactory income, management must balance the costs of inventory storage and obsolescence and the cost of tying up funds in inventory against possible losses of sales and other costs associated with keeping too little inventory on hand.

Standing alone, a single financial ratio may not be informative. Investors gain greater insight by computing and analyzing several related ratios for a company. Financial analysis relies heavily on informed judgment. As guides to aid comparison, percentages and ratios are useful in uncovering potential strengths and weaknesses. However, the financial analyst should seek the basic causes behind changes and established trends.

Summary of Ratios

Liquidity Ratios	**Formula**	**Significance**
Current (or working capital) ratio	Current assets / Current liabilities	Test of debt-paying ability
Acid-test (quick) ratio	Quick assets (cash + marketable securities + net receivables) / Current liabilities	Test of immediate debt-paying ability
Inventory turnover	Cost of goods sold / Average inventory	Test of whether or not a sufficient volume of business is being generated relative to inventory

Interpretation and Use of Ratios

Analysts must be sure that their comparisons are valid—especially when the comparisons are of items for different periods or different companies. They must follow consistent accounting practices if valid interperiod comparisons are to be made.

Also, when comparing a company's ratios to industry averages provided by an external source such as Dun & Bradstreet, the analyst should calculate the company's ratios in the same manner as the reporting service. Thus, if Dun & Bradstreet uses net sales (rather than cost of goods sold) to compute inventory turnover, so should the analyst.

Facts and conditions not disclosed by the financial statements may, however, affect their interpretation. A single important event may have been largely responsible for a given relationship. For example, competitors may put a new product on the market, making it necessary for the company to reduce the selling price of a product suddenly rendered obsolete. Such an event would severely affect net sales or profitability, but there might be little chance that such an event would happen again.

Analysts must consider general business conditions within the industry of the company under study. A corporation's downward trend in earnings, for example, is less alarming if the industry trend or the general economic trend is also downward.

Investors also need to consider the seasonal nature of some businesses. If the balance sheet date represents the seasonal peak in the volume of business, for example, the ratio of current assets to current liabilities may be much lower than if the balance sheet date is in a season of low activity.

Potential investors should consider the market risk associated with the prospective investment. They can determine market risk by comparing the changes in the price of a stock in relation to the changes in the average price of all stocks.

Potential investors should realize that acquiring the ability to make informed judgments is a long process and does not occur overnight. Using ratios and percentages without considering the underlying causes may lead to incorrect conclusions.

Even within an industry, variations may exist. Acceptable current ratios, gross margin percentages, debt to equity ratios, and other relationships vary widely depending on unique conditions within an industry. Therefore, it is important to know the industry to make comparisons that have real meaning.

Demonstration Problem

The balance sheet and supplementary data for Xerox Corporation follow:

Xerox Corporation Balance Sheet 20XX December 31(USD millions)

	20XX

Assets	
Cash	$ 1,741
Accounts receivable, net	2,281
Finance receivables, net	5,097
Inventories	1,932
Deferred taxes and other current assets	1,971
Total current assets	$ 13,022
Finance receivables due after one year, net	7,957
Land, buildings, and equipment, net	2,495
Investments in affiliates, at equity	1,362
Goodwill	1,578
Other assets	3,061
Total assets	$ 29,475
Liabilities and stockholders' equity	
Short-term debt and current portion of long-term debt	$ 2,693
Accounts payable	1,033
Accrued compensation and benefit costs	662
Unearned income	250
Other current liabilities	1,630
Total current liabilities	$ 6,268
Long-term debt	15,404
Liabilities for post-retirement medical benefits	1,197
Deferred taxes and other liabilities	1,876
Discontinued policyholders' deposits and other operations liabilities	670
Deferred ESOP benefits	(221)
Minorities' interests in equity of subsidiaries	141
Preferred stock	647
Common shareholders' equity (108.1 million)	3,493
Total liabilities and shareholders' equity	$ 29,475

- Cost of goods sold, USD 6,197.
- Net sales, USD 18,701.
- Inventory, January 1, USD 2,290.
- Net interest expense, USD 1,031.
- Net income before interest and taxes, USD 647.
- Net accounts receivable on January 1, USD 2,633.
- Total assets on January 1, USD 28,531.

Compute the following ratios:

1. Current ratio.
2. Acid-test ratio.
3. Inventory turnover.

Solution to Demonstration Problem

1. Current ratio: $\frac{Current\ Assets}{Current\ liabilities} = \frac{USD\ 13{,}022{,}000{,}000}{USD\ 6{,}268{,}000{,}000} = 2.08 : 1$
2. Acid-test ratio: $\frac{Quick\ Assets}{Quick\ liabilities} = \frac{USD\ 9{,}119{,}000{,}000}{USD\ 6{,}268{,}000{,}000} = 1.45 : 1$
3. Inventory turnover: $\frac{Net\ sales}{Average\ Inventory} = \frac{USD\ 18{,}701{,}000{,}000}{USD\ 2{,}111{,}000{,}000} = 8.86\ times$

2,111 million is the average of 2,290 and 1,932 mm, the inventories at the beginning and end of the year.

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16.6: Ethical Practices in Accounting

What you'll learn to do: discuss the importance of ethical practices in accounting and the implications of unethical behavior

In this section you'll learn why ethical accounting practices are so important and what happens when they *aren't ethical.*

Learning Objectives

- Discuss the impact of the Sarbanes-Oxley Act on accounting practices

Ethics in Accounting

Due to a series of recent corporate collapses, attention has been drawn to ethical standards within the accounting profession. These collapses have caused a widespread disregard for the reputation of the accounting profession. To combat the criticism and prevent unethical and fraudulent accounting practices, various accounting organizations and governments have developed regulations and guidelines aimed at improved ethics within the accounting profession.

The following video is just one example of the type of activities that have brought the accounting profession under fire for what can best be described as questionable business practices.

Why Should an Accountant Be Ethical?

Throughout this module you have read about the wide range of people and institutions that rely on accurate accounting information to make important decisions. Despite the best efforts of FASB and GAAP, accountants and accounting firms have become increasingly "creative" in reporting the financial position of businesses and in some cases have committed outright fraud. The consequences of unethical practices in financial reporting have cost taxpayers billions of dollars, employees their jobs, and the accounting profession its untarnished reputation. Unfortunately, despite efforts by professional organizations like the AICPA and legislation by the U.S. Federal Government, there is still a subset of the accounting profession that places profit before ethics.

The **AICPA Code of Professional Conduct** is a collection of codified statements issued by the American Institute of Certified Public Accountants that outline a CPA's ethical and professional responsibilities. The code establishes standards for auditor independence, integrity and objectivity, responsibilities to clients and colleagues and acts discr to the accounting profession. Unfortunately, the opening principle of the code is that membership, and therefore adherence, to the code is voluntary. This means that an accountant is never under a legal responsibility to adhere to the code and can renounce the code and membership in the AICPA at any time.

The Sarbanes-Oxley Act

Sarbanes-Oxley (SOX) was named after sponsors U.S. Senator Paul Sarbanes and U.S. Representative Michael G. Oxley. President George W. Bush signed it into law, stating that it included "the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt. The era of low standards and false profits is over; no boardroom in America is above or beyond the law."

The bill, which contains eleven sections, was enacted as a reaction to a number of major corporate and accounting scandals, including those affecting Enron, Tyco International, Adelphia, Peregrine Systems, and WorldCom. These scandals cost investors billions of dollars when the share prices of affected companies collapsed, and shook public confidence in the U.S. securities markets.The sections of the bill cover responsibilities of a public corporation's board of directors, adds criminal penalties for certain misconduct, and required the Securities and Exchange Commission to create regulations to define how public corporations are to comply with the law.

As a result of SOX, top management must individually certify the accuracy of financial information. In addition, penalties for fraudulent financial activity are much more severe. Also, SOX increased the oversight role of boards of directors and the independence of the outside auditors who review the accuracy of corporate financial statements. The Sarbanes-Oxley Act has been cited as a positive influence on the accounting profession for nurturing an ethical culture as it forces top management to be transparent and employees to be responsible for their acts whilst protecting whistleblowers. SOX has also been praised by a cross-section of financial industry experts, citing improved investor confidence and more accurate, reliable financial statements. The CEO and CFO are now required to unequivocally take ownership for their financial statements under Section 302, which was not the case prior to SOX.

As in any area of business, ethical practices are "good business," but when individuals place their personal interests or wealth above those of the stakeholders, the consequences can be far reaching. It is only through the adherence to ethical reporting and GAAP that the accounting profession can regain the respect and prestige the profession once had and deserves.

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16.7: Putting It Together- Accounting and Finance

Synthesis

Whether or not this module convinced you to pursue a career in accounting, by now you have acquired a working knowledge of some of the basics of financial accounting, as well as the importance of accuracy in the presentation of financial information to stakeholders. Whether you are running a bake sale or a multinational corporation, understanding the relationship between revenues and expenses is critical for success. The misdeeds of corporate executives and their accountants have peppered the news for the last decade; but, the vast majority of accountants and their clients follow a strict code of ethics and observe the laws and guidance provided by Congress, FASB, and AICPA. One of the best ways to protect yourself and your business against becoming involved in a financial scandal is to have a solid working knowledge of basic accounting principles so that you can recognize and correct any irregularities.

Summary

Accounting in Business

In short, accounting is the language of business—all business. Accounting represents all of the financial transactions of a business in a format that can be interpreted and understood by both internal and external stakeholders.

Key Financial Statements

When businesses present their financial condition to external stakeholders, taxing authorities, investors, and the general public, the most common format for this information is one of four key financial statements. These four statements are the Balance Sheet, Income Statement, Statement of Owners Equity, and Statement of Cash Flows. These four statements, although representing different facets of the company's finances, are all interconnected and create a birds-eye view of the company's financial position.

The Break-Even Point

Businesses, both large and small, are concerned with determining the point at which their revenues exceed their expenses and they begin to make a profit. The point at which revenue equals expenses (and profit is therefore $0) is called the break-even point.

Financial Ratios

Financial ratios allow business to represent the relationships between components of their financial operations as ratios. Financial ratios are used to measure a firm's financial health in four areas: liquidity, long-term solvency, profitability tests, and the market. These ratios can be used to compare the company's performance across periods (months, quarters, years) or to similar companies within the same industry.

Ethical Practices in Accounting

Certified public accountants (CPAs) and certified management accountants (CMAs) are bound to the Code of Ethics established by their licensing bodies. Generally accepted accounting principles (GAAP) and the Financial Accounting Standards Board (FASB) have established practices designed to ensure that the financial status of a company is "fairly and accurately" presented. Legislation such as the Sarbanes-Oxley Act has been passed by Congress to strengthen the emphasis on ethical practices in accountancy. Although stories of unethical conduct by companies such as Enron, WorldCom, and HP have made headlines, the overwhelming majority of individuals working as internal or external accountants follow the code of ethics and work hard to ensure that the information provided to stakeholders is fair and accurate.

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CHAPTER OVERVIEW

17: Using Technology to Manage Business Information

17.1: Why It Matters- Using Technology to Manage Business Information
17.2: Technological Changes in Business
17.3: How Businesses Use Information
17.4: Information Networks
17.5: Current Issues in IT
17.6: Putting It Together- Using Technology to Manage Business Information

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17.1: Why It Matters- Using Technology to Manage Business Information

Why learn how technology is used to manage business information?

In this module you will learn ways in which businesses use technology to turn data into information and then use that same technology to manage that information. In the 90's we talked about the dawn of the "digital age" where old processes were quickly converted to digital processes. That digital age of the 1990's and 2000's evolved into what we now refer to as the "information age." Technology has progressed so rapidly that businesses are able to capture billions of bytes of data everyday. This data is analyzed and converted into information and consequently we now consider ourselves to be living in the "information age." The primary characteristic of this information age is successful businesses are able to leverage information to create and maintain a competitive advantage over the competition. In fact, in today's world almost every aspect of business operations is impacted by technology to some extent. But, before we begin our discussion of technology, information and business, let's get some perspective on the "information age" in the video that follows.

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17.2: Technological Changes in Business

What you'll learn to do: Discuss the role of technology in business

Not since the industrial revolution has business experienced such rapid and profound changes as it has seen since 1990 and the launch of the World Wide Web. Since the days of dial-up, access to the Internet is available almost everywhere. It is rare these days for consumers to go into a coffee shop, library or any place of business and not be able to access a Wi-Fi signal. If there isn't a Wi-Fi signal in close range, most people still have access to the Internet via their cellular data connection on their smartphones and personal hotspots, no problem. With this anywhere/anytime access to the Internet, businesses created web applications to answer common needs of consumers. These applications can do everything from tracking food portions to sending massive amounts of information in a click of a button.

More people and companies are using cloud-based services for their business and store everything online instead of on a single device. This change will continue to have an enormous impact on the way business is done, transforming our once-traditional office environments and how people interact with companies on a regular basis. Flash drives are almost extinct with the prevalence of cloud storage, like iCloud, Google Drive, Dropbox and FTP sites. With so many new technologies permeating the way people access information and access each other, the forward momentum looks promising for future technological developments.

In this module we will examine how these technological advances have impacted business.

learning Objectives

- Explain how technology changes business.
- Explain Business Intelligence (BI) and its impact on business success.

Using Technology

Think about how you conduct business today as a consumer. The way that consumers identify and ultimately purchase products, goods and services has changed at an exceedingly rapid pace. This is a direct result of advances of the technology available to today's businesses. What most consumer do not see are the wide range of new and evolving technologies that businesses employ in the development, production and distribution of those products, goods and services. Although the type of technology a business employs is determined by their operations, we can classify the technologies used in business into several broad categories.

1. **Computers**. Desktop computers loaded with office and productivity software packages allow workers to write letters, analyze financial information, send and receive emails, and design sales presentations. The computer itself could be a desktop model with a separate monitor and keyboard, or a mobile laptop. There are two main types of computers. Personal computers (PCs) operate using Microsoft Windows are the most common, and Macintosh Computers using Apple Computer's operating system are popular among creative professionals.
2. **Software**. Software is loaded onto a computer to provide specific types of functionality. Software ranges from word processing programs such as MSWord to highly complex programs that allow developers to create virtual 3D images of a new product. Literally millions of software applications are available to business and selecting the most appropriate software to accomplish the business's objectives occupies much of the time of Information Technology personnel. For example, artificial intelligence/machine learning (AI) continues to gain in importance. Some estimates show that nearly 40 percent of businesses may be using AI to automate their processes by as early as 2019. Businesses are hoping that these AI programs will execute specific tasks, allowing businesses to gain a competitive edge and provide a higher-quality service experience for consumers.
3. **Networking**. Computers are often linked to form a network. This allows people within an organization to share documents or information, provide a central repository to store documents, or for people to communicate using email within an office. They also allow several computers to share a printer or storage device. A network can be limited to computers within a shared office, or span across multiple offices and locations.
4. **Telephone Systems**. You may not think of something as traditional as a telephone system as a technology, but today's business phone systems are quite complex. The most common type of phone system consists of a hardware unit that uses software to split the phone company line among individual handsets. The increasing use of automated attendants that help callers find the employee they are seeking, check their account balance, place a service call, check on the status of an order allow businesses to provide a level of customer service without the caller ever interacting with an employee of the business.
5. **Accounting Systems**. Although primarily a software package, accounting systems are a crucial to business success. Accounting systems keep track of every dollar a company spends along with every dollar of revenue. In addition, accounting systems are

capable of tracking labor costs, inventory levels, asset value and other pieces of financial information that managers need in order to make decisions about business operations. These systems can range from a relatively simple system such as QuickBooks to highly complex systems such as SAP.

6. **Computer Aided Manufacturing Systems**. No longer does the manufacturing process require hundreds of employees working on a production line. Computer Aided Manufacturing (CAM) is the use of software and computer controlled machinery to automate the manufacturing process. This can be something as simple as filling cupcake tins with batter at a large bakery facility to building aircraft component parts to later be assembled into a jumbo jet. As technology continues to evolve, computers will take on an even more prominent role in the design and manufacture of everyday household goods.

These broad categories of technology can be found, to some extent, in virtually every business today. However, business cannot sit idle as technology changes around them. Today's businesses must keep informed of new technologies in the same way that they must remain vigilant of changes in consumer demands. While leveraging existing technologies to their benefit, businesses must keep a watchful eye on emerging technologies such as Block Chain, virtual reality and machine learning in order to adopt the technologies that maximize efficiency and ultimately maximize revenue.

practice Question 17.2.1

Of the types of technology discussed on this page, which category would be considered the most pervasive for business use?

a. Telephone systems
b. Software
c. Computer aided manufacturing systems (CAM)
d. Accounting systems

Answer

b. With millions of software applications available, businesses can select the ones that accomplish their business objectives. If, in their opinion, there are no "off-the-shelf" applications that meet their business needs, many organization will create their own home-grown applications.

Technology's Influence on Business

Not since the Industrial Revolution and the introduction of the assembly line has business undergone such rapid change as it has since the birth of the Internet. The technological revolution of the last 20 years has fundamentally changed the ways the businesses do business with each other, their customers, their suppliers and business partners. How customers discover a business's products, goods and services is no longer bounded by geography. People on Main Street U.S.A. can shop the globe for goods and services that meet their needs at a price they are willing to pay. Think about the last thing you purchased. Count the ways that technology impacted your purchase.

In order to get an idea of how business is impacted by technology, let's follow Jim as he goes to a local retailer and purchases a dishwasher.

buying a dishwasher

Jim decides to purchase a new dishwasher, but before he heads out to the store he sits in his recliner and searches the Internet for dishwashers. He reads customer reviews and narrows his selection to 2 different models. He then goes to the websites of the companies that manufacture the two dishwashers and looks at the specifications, reads the warranty information and watches videos of people installing the dishwasher. While he is watching one of the videos a small box pops up and offers "live chat" with a customer service representative of Brand X.

He then goes to the website of the 3 local retailers that carry the dishwasher he wants and compares prices. He also checks to see if the dishwasher is in stock. He is on the website of Store A and while he is checking for the dishwasher an ad pops up and offers a 10 percent discount if he downloads and

uses Store A's app. He grabs his phone, downloads the app and logs back into the store website. Through the magic of "cookies" the information from his laptop appears on his phone and he continues shopping. With his decision made he completes the purchase online, using a verified secured server and pays for the dishwasher with his debit card.

Almost at the same time that he his the "confirm order" button on his phone the inventory level at Store A is adjusted to reflect Jim's purchase. Since the dishwasher Jim has just purchased only leaves 1 in stock, Jim's order triggers the store to request another dishwasher from its regional warehouse using real-time electronic data interchange. Before Jim can arrive at the store to pick up his new dishwasher, a replacement has been identified and robotic stock picking equipment is delivering it to the loading dock where it will be loaded onto a truck and delivered to Store A by 10 am the next day.

Jim gets home with his new dishwasher and gets it installed thanks to the video provided by the manufacturer. He goes online and "registers" his purchase, providing his email address. Over the course of the next 6 months Jim will receive emails from the manufacturer of the dishwasher that range from a survey of customer satisfaction to an offer to purchase an extended warranty. He will also begin to see advertisements for other kitchen appliances, related products and "offers" from Store A and their competitors.

So, from the start everything about Jim's purchase is touched by technology. We haven't even talked about how the dishwasher was designed using CAD/CAM software, how computer integrated manufacturing produced the dishwasher or how the component parts of the dishwasher were made using robots and computerized machinery. As we said at the start of the Module—technology has revolutionized the way that business does business.

For an example of the future of technology and business, look at Amazon's latest venture – "Amazon Go." **Amazon Go** is a chain of grocery stores operated by the online retailer Amazon, currently with three locations in Seattle, Washington, two in Chicago, Illinois and one in San Francisco, California. The stores are partially-automated, with customers able to purchase products without being checked out by a cashier or using a self-checkout station. The first store, located in the company's Day 1 building, opened to employees on December 5, 2016, and to the public on January 22, 2018. The flagship store has prepared foods, meal kits, limited groceries, and liquor available for purchase. The video that follows will give you some insight into how Amazon is using technology to totally transform the shopping experience.

In summary, consider the following ways that technology has changed business[1].

1. **Mobile Solutions**. With the rise of Generation Y (Millennials) more people are using mobile devices to buy, sell, shop, find local businesses, and share their retail experiences with friends, acquaintances, prospects, and Facebook strangers every day.
2. **Cloud Computing.** Cloud computing allows businesses large and small to move some of their operation to third-party servers accessible via Internet connectivity. Not only does this allow for rapid (on-demand) data and mobility it does so without the fear of downtime, crashes, or permanently lost data.
3. **Extreme Customer Segmentation**. With the flow of more and more data, it's easier now than ever before to understand the customers you're looking for. Even a simple Google account will let you know where your visitors are from, what type of browser they're using, how they found your website, what they do while on it, how long they stay, and at which point they decided to leave.
4. **Connectivity**. Technology has also increased the ease with which we can all stay in touch. Whether it's having your coworkers and employees available via text/video chat at a moment's notice, or being able to send targeted promotional email blasts to pre-qualified customers when they're shopping at nearby businesses, the rise of mobile technology has blended almost seamlessly with communication software to create a hyper-real web of real time information.
5. **Social Impact.** The rise of social networking has figuratively shrunk the world and now users can connect without regard to geographical obstacle, financial background, or even social status. Indeed, years ago you may have been able to skate by on "okay" customer service and product offerings but now you'll likely incur a hateful rant on Facebook or a bad review on rating sites like Yelp.

Businesses are forced to ride the wave of technology or risk going the way of Blockbuster, Toy 'R Us, Radio Shack or Sears. The reality of business today is that technology will continue to force them to adapt and adopt or risk extinction.

practice question 17.2.2

All of the following represent ways that technology has changed business EXCEPT:

a. Connectivity
b. Social Networking
c. Management Paradigms
d. Cloud Computing

Answer

C. Although management has been impacted by the rise of advanced technology, it is not one of the categories listed by the author

Business Intelligence

Business intelligence (BI) is a technology-driven process for analyzing data and presenting useful information to help executives, managers and other end users make informed business decisions. The potential benefits of using BI tools include accelerating and improving decision-making, optimizing internal business processes, increasing operational efficiency, driving new revenues and

gaining competitive advantage over business rivals. BI systems can also help companies identify market trends and spot business problems that need to be addressed. In short, BI technologies allow a business to view their operations, past, present and future.

BI technologies handle large amounts of data to help identify, develop and otherwise create new strategic business opportunities. Identifying new opportunities and implementing an effective strategy based on insights can provide businesses with competitive market advantage and long-term profitability.

The video below will provide you with an overview of how a company can use BI to improve its outcomes and attain its goals.

practice question 17.2.3

What is Business Intelligence (BI)

a. The ability to forecast business trends using only intuition.
b. The capability to analyze large quantities of business information and present it in a manner that facilitates better business decisions.
c. The smarts gained from an advanced business degree.
d. The process of protecting sensitive business data from malicious users.

Answer

b. BI is important to all businesses, allowing decision-makers to make sense of big data.

BI is most effective when it combines data derived from the market in which a company operates (external data) with data from company sources internal to the business such as financial and operations data (internal data). When combined, external and internal data can provide a complete picture which, in effect, creates an “intelligence” that cannot be derived from any singular set of data. Business intelligence tools empower organizations to gain insight into new markets, to assess demand and suitability of products and services for different market segments and to gauge the impact of marketing efforts.

Other ways a business can use BI to improve performance include

- Business Process Management. Performance metrics and benchmarking inform business leaders of progress towards business goals. BI tools can help a business boost internal productivity by focusing their efforts on what is important.

- Decision Making. BI analytics such as data mining and statistical analysis quantify processes for a business to make the best decisions. BI can help a business identify areas to cut costs or how to distribute budget allocations.
- Business Planning. Businesses can use BI data to develop both short term goals and long term strategy. Businesses can gain insight into their customers and market trends, allowing them to make decisions about current and future operations, products, goods or services.
- Collaboration. BI can facilitate collaboration both inside and outside the business by enabling data sharing and electronic data interchange. Many businesses use BI tools to communicate with suppliers, reducing lead times and inventory levels. By sharing data among partners, each business has up-to-the-minute information on everything from delivery times to price changes.

If BI is so powerful then why hasn't it always been used by businesses? It has been used widely by businesses for decades, but in the past, only the information technology experts within a business had access to a few, highly complex BI tools and applications. As technology has evolved; however, there now exists a broad range of BI tools that a company can employ. Additionally, this new generation of BI tools are typically fairly simple to use so now a broader range of users within the business are able to get involved in analyzing and using data to make decisions. The result is that rather than the historical approach of just a few highly specialized data people being the only ones with visibility into the data, now people such as managers, supervisors, sales associates, and marketing specialists can leverage the power of internal and external data to their benefit and to the benefit of the organization.

> One example of how business intelligence systems have been maximized is at women's underwear manufacturer Maidenform. Their CIO Bob Russo said recently after implementing BI, "Providing targeted information at the right place and time is central to improving the decision-making process. This would allow us to gain a competitive advantage in the marketplace as well as increase retail customer, shopper and shareholder value. We want to make sure that we are able to deliver 'one version of the truth' and deliver information that is actionable. We do not want to just deliver data."

1. https://gomodus.com/eight-ways-technology-changing-business/ ↵
2. https://www.matillion.com/insights/6-real-life-examples-of-successful-business-intelligence-systems/ ↵

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17.3: How Businesses Use Information

What you'll learn to do: discuss ways in which information is used in business

Traditionally we think about value in business in terms of assets—property, plants, equipment, inventory and even human resources. The explosion of technology over the last decade has made us re-think what is valuable. In fact, what many businesses today consider to be their most valuable asset cannot be held in your hand because it is the *information* generated by the collection of billions of bits of data. In fact, the data that businesses gather about their customers is, to the most progressive companies, invaluable! For example, when you visit a company's website, data is captured about what you looked at: what colors you preferred, how long you remained on a page and yes, even your physical location.

Companies take that "data" and turn it into useful information. They can then use this information to push advertising to you, not just through their website but to your social media accounts, your email, and even your cell phone. As the collection of data becomes easier and more cost effective, businesses are constantly generating new and better information about the business environment. In this section you will learn the difference between data and information, the types of data that businesses collect, and, finally, how businesses use information.

Learning Objectives

- Describe the different types of data businesses collect
- Explain how businesses use information.

Data vs. Information

Many people are under the impression that the terms "data" and "information" are interchangeable and mean the same thing. However, there is a distinct difference between the two words. **Data** can be any character, text, word, number, and, if not put into context, means little or nothing to a human. However, **information** is data formatted in a manner that allows it to be utilized by human beings in some significant way. An individual has an almost unlimited amount of data associated with him or herself. This data is of little use to business in it's raw, unorganized form. It is not until the data is formatted or compiled into something meaningful that business has information about the individual. For example, suppose the department store Big Box is collecting data about its customers from a loyalty card program and online customer surveys. If collects the following data about a particular customer:

- Age: 34
- Big Box Account #: 123456
- Gender: Female
- Zip Code: 22322
- Children: 2
- Marital Status: Married
- Last Purchase: Jogging Pants

These pieces of data alone are not particularly useful to Big Box. It is not until the data is compiled that Big Box begins to get a "picture" of the customer behind account #123456. Transforming this data into information, Big Box is able to know that this customer is a married female who has 2 children and enjoys jogging. They also know that because she lives in zip code 22322 that she is most likely to shop at their store at Halifax Mall since the mall is in the same zip code as the customer's home address. If Big Box wants to market to her successfully, then they will use this information to include her in an upcoming active wear promotion. Also, since she has children they will also include her in promotions that include children's wear. The key to collecting data and turning it into useful information for Big Box is that it is a continual process.

So, Big Box includes Customer #123456 in a future mailing and when she comes into the store and makes a purchase her loyalty card records that she purchased several items in the toddler clothing department. This data can be useful information when Big Box sends out information about their annual "Santa Comes to Town" promotion. They can use the purchase data to inform them that Customer #123456 has a toddler and toddlers love to come see Santa!

practice question 17.3.1

What is the difference between "data" and "information"?

a. Data is information coming out of a computer, while information comes from television and newspapers.
b. Data is bits, bytes, characters, and values that mean little or nothing to a human being. Information is data expressed in a format that can be understood and utilized by people.
c. Data needs to be stored in a database while information can be printed in reports, books and journals
d. Data is numerical in nature, while information is usually expressed in words.

Answer

b. Without context or format, data is not information

Later in the year, Customer #123456 makes an online purchase of a pair of men's work boots and a men's heavyweight coat. The data that comes into Big Box may look like this:

- Customer #123456
- Date: 10/5/2018
- Item #56-9876 Cougar Work Boots, Size 11
- Item #43-2341 Men's Heavyweight Denim Coat, Size XL

Not very interesting data by itself. But, now Big Box can use this data to have even better information about Customer #123456. They know that Mr. #123456 probably works outdoors, possibly in a skilled trade; hence the need for work boots and a heavy weight coat. When Big Box spends their promotion dollars on a men's suit sale they will not target Customer #123456 because they have "information" about them, gathered from these individual pieces of data. As Customer #123456 makes additional purchases, visits the company's web site and responds to special offers they will collect more and more data. Every piece of data collected will be useful in giving Big Box more and more information about this particular customer. Now, imagine this data is collected on every customer for every purchase over a period of years. The quantity of raw data collected is staggering and the challenge for Big Box is to store this data in a manner that allows it to be turned into information. This is where data warehousing and data mining come into play.

Business Data

Information flows in and out of a business in many different direction. The type of data a business collects is informed by a business's goals and objectives. Computing systems can collect a dizzying array of data about the world around us. Businesses must decide what type of data they need to inform their business decisions and then determine where and how that data can be collected. The types of data that businesses collect can be broken down into 5 broad categories: business process, physical world observations, biological data, public data and personal data. Let's examine each of these categories of data in greater detail.

Business Process Data. In order to remain competitive businesses must find ways to increase efficiency while maintaining quality standards for their products, goods and services. In order to continuously improve their operations, businesses collect data regarding their business processes. This data can range from collecting data on the number of days it takes their customers to pay invoices to the tie it takes to assemble and package a product. In order to collect this type of data, many businesses employ enterprise resource planning systems. ERP systems track business resources—cash, raw materials, production capacity—and the status of business commitments: orders, purchase orders, and payroll. The applications that make up the system share data across various departments (manufacturing, purchasing, sales, accounting, etc.) that provide the data. Another source of process data is Point of Sale (POS) systems. We are all familiar with these – they are the systems that scan the barcodes on our purchases when we check out at the grocery. When a cashier scans the barcode on an item that scan collects data that can be used in inventory management, loyalty programs, supplier records, bookkeeping, issuing of purchase orders, quotations and stock transfers, sales reporting and in some cases networking to distribution centers. The more data a business has about its processes the more likely it will find opportunities to improve or enhance those processes.

Physical-world observations. Technology has made it possible for business to capture real-time data about the physical world. This data is collected by the use of devices such as radio frequency identification (RFID), wireless remote cameras, GPS, sensor technology and wireless access points. By inserting computer chips into almost any object companies are able to track the movements of that item and in some cases control the object. One of the early adopters of such technology was the On-Star system

installed in millions of U.S. automobiles. Through the use of a combination of RFID, GPS and satellites if a car owner inadvertently locked their keys in the car one call to On-Star and like magic the doors to their vehicle would be unlocked. In another application of RFID technology, Delta Airlines is now able to send passengers real-time information about the location of their checked baggage. In fact, starting in 2016 Delta fliers who check bags can receive mobile notifications as bags are loaded onto and off of airplanes and when they reach carousels for pickup. By embedding RFID chips in each luggage tag, Delta has achieved an eye-popping 99.9% tracking success rate, according to the company. “In the same way that customers want information at their fingertips about flight changes, we know our customers want clear visibility to their checked bags,” says Tim Mapes, Delta’s chief marketing officer[1].

Biological Data. If you have a newer smart phone it is possible that you can unlock your phone by simply looking at the screen. This is made possible by facial recognition software. Unlocking your laptop with your fingerprint is another example of biological data available to businesses. Although things like voice and face recognition, retinal scans and biometric signatures are currently used primarily for security purposes, it may be possible in the future for this type of data to allow for product and service customization.

Public Data. Businesses have an almost endless source of data available to them free from public sources. Whenever you log onto the Internet, use instant messaging, send emails an electronic footprint is left behind. For now this data is considered to be “public” and businesses collect, share and even sell this type of data every day. This has become a very controversial topic in the past several years and recent legislation by the EU regarding this type of data may be the first step in limiting the collection and use of this type of public data. For additional information on this groundbreaking legislation follow this link to the European Commission: European Commission and Data Protection

Personal Data. Much like data that is considered to be “public” data, as we use technology we provide a wealth of personal data that businesses can use to reveal much about our personal preferences, habits, pastimes, likes and dislikes. For example, Facebook uses information people provide — such as their age, gender and interests — to target ads to a specific audience. Advertisers tell Facebook which demographics they want to reach, and then the social media giant places the ads on related accounts. How businesses collect and use this data is also highly controversial as exemplified by recent disclosures that Facebook has been collecting and selling personal information gathered from subscribers’ activities on the social network. Much like the controversy surrounding publicly available data, what rights an individual has to his or her data is currently being debated globally.

The volume of data available to businesses continues to increase exponentially and as more and more data becomes available collecting, storing and analyzing that data becomes increasingly complex. This data explosion has made data warehousing and data mining of greater importance to business as we will see in the next section.

practice question 17.3.2

Businesses collect a variety of data listed below EXCEPT:

a. Business process information
b. Personal data
c. Public data
d. Regulatory data

Answer

d. Regulatory data

Data Mining and Warehousing

Billions and billions of bits of data flood into an organization’s information system, but how does that data get utilized effectively? The challenge lies not so much with the collection or storage of the data: today, it is possible to collect and even store vast amounts of information relatively cheaply. The main difficulty is figuring out the best and most efficient way to extract and manage the relevant data. In this section you will learn how organizations not only warehouse but then mine the data they collect.

Did you ever think about how much data you yourself generate? Just remember what you went through to start college. First, you had to fill out application forms asking you about test scores, high school grades, extracurricular activities, and finances, plus demographic data about you and your family. Once you’d picked a college, you had to supply data on your housing preferences, the curriculum you wanted to follow, and the party who’d be responsible for paying your tuition. When you registered for classes, you

gave more data to the registrar's office. When you arrived on campus, you gave out still more data to have your ID picture taken, to get your computer and phone hooked up, to open a bookstore account, and to buy an on-campus food-charge card. Once you started classes, data generation continued on a daily basis: your food card and bookstore account, for example, tracked your various purchases, and your ID tracked your coming and going all over campus. And you generated grades.

And all these data apply to just one aspect of your life. You also generated data every time you used your credit card and your cell phone. Who uses all these data? How are they collected, stored, analyzed, and distributed in organizations that have various reasons for keeping track of you?

Warehousing and Mining Data

How do businesses organize all of this data so that they can transform it into useful information? For most businesses this is where **data warehousing** comes into play. A data warehouse collects data from multiple sources (both internal and external) and stores the data to later be used in an analysis. The primary purpose of a data warehouse is to store the data in a way that it can later be retrieved for use by the business. Despite the name, **Data Mining** is not the process of getting specific pieces of data out of the data warehouse, but rather the goal of data mining is the identification of patterns and knowledge from large amounts of data. Large retailers such as WalMart and Target track sales on a minute-by-minute basis and data mining allows these large retailers to recognize changes in purchasing behavior in an extremely short amount of time. They can quickly make adjustments to inventory levels based on the information gathered from thousands of individual transactions as a result of data mining. Clearly understanding consumer behavior is a primary goal of data mining. The following video explains just how businesses use data mining to understand and predict consumer behavior.

practice question 17.3.3

What is the difference between data warehousing and data mining?

a. Data warehousing is a strategy to keep data secure while Data Mining with analyzing trends within that information
b. Data warehousing is a strategy to keep data secure while data mining involves sharing information across a variety of networks
c. Data warehousing is a way to archive old information while data mining allows a user to lookup a specific fact.
d. Data warehousing and data mining are the same thing

Answer

a. Data warehousing is needed to aggregate massive amounts of data so that it can be mined for analysis.

Today businesses are treating the Internet as a massive data warehouse and are using data mining techniques to gather data about not just existing customers, but potential customers. Data mining tools such as Scrapy, Nutch and Splash allow businesses to learn more about customers, competitors, compare prices and even find new customers and sales targets. As the quantity of data businesses can collect continues to grow, having an effective data warehousing system that can be easily mined has become increasingly critical to business success.

Information and Business

We can summarize how businesses use information by saying, "businesses use information to gain a competitive advantage." Simply put a competitive advantage is what makes a business's goods or services superior to all of a customer's other choices. Internally; however, we can examine closer how information is used in both primary and support activities within the business.

Information and Primary Business Activities

The primary activities are the functions that directly impact the creation of a product or service. The goal of the primary activities is to add more value than they cost. The primary activities are:

- Inbound logistics: These are the functions performed to bring in raw materials and other needed inputs. Information can be used here to make these processes more efficient, such as with supply-chain management systems, which allow the suppliers to manage their own inventory.
- Operations: Any part of a business that is involved in converting the raw materials into the final products or services is part of operations. From manufacturing to business process management, information can be used to provide more efficient processes and increase innovation through flows of information.
- Outbound logistics: These are the functions required to get the product out to the customer. As with inbound logistics, information can be used here to improve processes, such as allowing for real-time inventory checks.
- Sales/Marketing: The functions that will entice buyers to purchase the products are part of sales and marketing. Information is critical to every aspect of sales and marketing. From online advertising to online surveys, information can be used to innovate product design and reach customers like never before. The company website can be a sales channel itself as we have seen with Amazon.
- Service: The functions a business performs after the product has been purchased to maintain and enhance the product's value are part of the service activity. Service can be enhanced via technology as well, including support services through websites and mobile apps.

Information and Support Activities

The support activities are the functions in an organization that support, and cut across, all of the primary activities. The support activities are:

- Firm infrastructure: This includes organizational functions such as finance, accounting, and quality control, all of which depend on information; the use of ERP systems is a good example of the impact that information can have on these functions.
- Human resource management: This activity consists of recruiting, hiring, and other services needed to attract and retain employees. Using the Internet, HR departments can increase their reach when looking for candidates. There is also the possibility of allowing employees to use technology for a more flexible work environment.
- Procurement: The activities involved in acquiring the raw materials used in the creation of products and services are called procurement. Business-to-business e-commerce can be used to improve the acquisition of materials.

This brief analysis sheds some light onto how businesses can use information to gain a competitive advantage. As you can see, the use of information cuts across the entire organization. Although the uses may vary from area to area one thing that is consistent is that the use of accurate, timely information can improve business processes and thereby enhance the customer experience. When the customer experience is enhanced, revenues rise, profits rise and business flourishes. Information is quickly becoming the lifeblood of business and its importance in the long-term success of an organization cannot be overstated.

practice question 17.3.4

Thinking about the business and support activities outlined in this section, what would you consider to be the most important outcome of how businesses use information today?

a. to enhance the customer experience in order to gain competitive advantage
b. to better manage business processes
c. to recruit and hire the best employees
d. to improve sales and marketing

Answer

a. This is by far the most valuable outcome of how businesses use information today as it affects market share, revenues, and the value of the company itself

1. https://news.delta.com/delta-introduces-innovative-baggage-tracking-process-0 ↵

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17.4: Information Networks

What you'll learn to do: compare the ways that businesses can manage information

Billions and billions of bits of data flood into an organization's information system, but how does that data get utilized effectively? The challenge lies not so much with the collection or storage of the data: today, it is possible to collect and even store vast amounts of information relatively cheaply. The main difficulty is figuring out the best and most efficient way to extract and manage the relevant data and resulting information. In this section you will learn how organizations use a variety of networks to manage their information.

Learning Objectives

- Discuss how businesses can use intranets and extranets to manage information
- Discuss how businesses can use Virtual Private Networks (VPNs) to manage information

The Internet and Cloud Computing

Once it's grown beyond just a handful of employees, an organization needs a way of sharing information. Imagine a flower shop with twenty employees. The person who takes phone orders needs access to the store's customer list, as do the delivery person and the bookkeeper. Now, the store may have one computer and everyone could share it. It's more likely, however, that there are a number of computers (several for salespeople, one for delivery, and one for bookkeeping). In this case, everyone needs to be sure that customer records have been updated on all computers every time that a change is required. Traditionally the business would install a network (LAN) to allow the various computers to talk to one another and share information. Today businesses are looking to the cloud to provide a network solution.

Cloud Computing

So, what is cloud computing? Watch the following video, which describes some of the uses and benefits of cloud computing.

The term "cloud computing" means performing computer tasks using services provided over the Internet. In cloud computing a company's data and applications are stored at an offsite data center that is then accessed via the Internet (the cloud). So when you hear or read that an individual or company is using the "cloud" or technology firms, such as IBM, Hewlett-Packard, and Salesforce.com, are offering cloud services, just substitute the word "Internet" for "cloud" and things will make sense.

You might be surprised to learn that you're already using the cloud—that is if you use Facebook (which is very likely—in fact, just mentioning Facebook here might prompt you to stop studying and check out your friends' pages). How do you know that Facebook is a cloud application? Remember the trick: just substitute the word "Internet" for "cloud." The Facebook computer application lets you store information about yourself and share it with others using the Internet.

practice question 17.4.1

How do businesses use the Internet to manage information?

a. Businesses use cloud (Internet) computing as the primary way to manage their information
b. Businesses can use the internet to send and receive email.
c. Businesses can use the Internet to host their accounting systems
d. Businesses can use the internet to track customer activity

Answer

a. Cloud Computing offers businesses both functionality (applications and storage) as well as connectivity (a network to allow access to the applications and stored data).

Advantages and Disadvantages of Cloud Computing

In making a decision whether or not to use cloud computing to store and share information, a business should consider some of its advantages and disadvantages.

Advantages

1. *Cost Savings*—By "renting" software rather than buying it the cloud can reduce. In most instances, the monthly fee to "use" software is generally less than the combined cost of buying, installing, and maintaining the software internally. On the hardware site, housing data in a service provider's facilities (such as Amazon or Google), rather than in-house, reduces the large outlay of cash needed to build and maintain data centers.
2. *Speed of Delivery*—Purchasing and installing software and data processing equipment can be time consuming. A cloud computing service provider can get applications up and running in a minimal time frame and often without interrupting normal business operations.
3. *Scalable*— As businesses grow it's often difficult to gauge the level of technology needs. If businesses overestimate their requirements, they end up paying for technology they don't need. If they underestimate, efficiency goes down, and the experience for customers may diminish. By using cloud computing businesses are able to have exactly what they need at their disposal at any point in time.
4. *Employees Can Be Mobile*—The use of cloud computing frees workers from their desks and allows them to work wherever they are. As applications move to the cloud, all that is needed for employees to connect to their "offices" is the Internet. This mobility benefit also makes it easier for employees to collaborate on projects and connect with others in the company.
5. *Information Technology Staff*— Finding experienced and knowledgeable information technology staff is a continuing problem for many businesses. By using cloud computing, businesses can reduce their human resource needs by shifting some of the work to outside vendors who have a staff of highly skilled individuals.

Disadvantages

Although the advantages of moving to a cloud environment outnumber the disadvantages, the following disadvantages are cause for concern:

1. *Disruption in Internet Service*— Since both applications and data are accessed via the Internet, if the Internet is unavailable because of a disruption this could create serious problems for a business.
2. *Security*—Many companies are reluctant to trust cloud service providers with their data because they're afraid it might become available to unauthorized individuals or criminals. This is a particular concern to business that collect and store sensitive client information.
3. *Service Provider System Crash*—Organizations considering moving to the cloud are often concerned about the possibility of a computer service crash at their service providers' facilities. If the service provider experiences an outage, then the business is in

effect cut off from its data and operations.

Although there are some disadvantages, using cloud computing to manage information is the new normal for many businesses. In fact, according to Forbes magazine, the cloud computing market is estimated to grow to $411 billion by 2020. The global cloud computing services market size is driven by many factors. The most important factor, which is driving the market, is the cost effectiveness. With the deployment of cloud computing services, organizations can save more than 35% of the annual operating costs of their information systems. Clearly the future for the cloud is sky high!

Intranets and Extranets

Intranets

Increasingly, businesses are relying on intranets to deliver tools such as collaboration, scheduling, customer relationship management tools, and project management to increase the productivity of the organization. An **intranet** is a private network accessible only to an organization's staff. Unlike the Internet, an internal intranet provides a wide range of information and services to employees of an organization but these tools and information are unavailable to the public. A company-wide intranet is an important focal point of internal communication and collaboration, and can provide a business with a single starting point to access both internal and external resources. Larger businesses allow users within their intranet to access the public Internet through firewall servers. Because businesses have the ability to screen both incoming and outgoing traffic, they are able to keep the security of the intranet intact. In its simplest form, an intranet is established with the technologies for local area networks (LANs) and wide area networks (WANs).

Some of the advantages and benefits a company can realize from establishing a robust intranet are as follows.

- **Workforce productivity**. Intranets can help users to locate and view information faster and use applications relevant to their roles and responsibilities.
- **Enhanced collaboration**. Information is easily accessible by all authorized users, which enables teamwork. Being able to communicate in real-time through integrated third party tools promotes the sharing of ideas and helps boost a business' productivity
- **Time Savings**. Intranets allow organizations to distribute information to employees on an as-needed basis in real time. Employees may link directly to relevant information as soon as the organization makes it available on the intranet.
- **Reduced Costs**. Users can view information and data via web-browser rather than maintaining physical documents such as procedure manuals, internal phone list and requisition forms. This can potentially save the business money on printing, duplicating documents, and the environment as well as document maintenance overhead.
- **Improved Communication.** Intranets can serve as powerful tools for communication within an organization. A great real-world example of where an intranet helped a company communicate is when Nestle had a number of food processing plants in Scandinavia. Their central support system had to deal with a large number of requests for information every day. When Nestle decided to invest in an intranet, they quickly realized the savings. In fact, the savings from the reduction in calls was substantially greater than the investment in the intranet[1].

Extranets

In some cases organizations make the decision to allow external parties such as customers and suppliers to have access to their intranet. When these outside parties are provided access to a subset of the information accessible from an organization's intranet the intranet becomes an **extranet**. For example a large construction company may share drawings with architects or inspectors, photographs to their customers and loan documents to their bankers by implementing online applications that allow these external parties to access and even mark-up and make changes to documents. In essence, the company will use an extranet to manage project-related communications. One of the biggest advantages of establishing an extranet is that a business can share large quantities of data using EDI or electronic data interchange. Data such as invoice and order that were traditionally transmitted via paper can now instantly be shared among organizations. Some of the most sophisticated extranets are run by large retailers like Walmart and Target who constantly transmit data via their extranet to vendors and suppliers, ensuring that merchandise arrives when it is needed, where it is needed.

Like intranets, extranets have some distinct advantages for the organizations establishing them. Several of these benefits are explained below.

- **Build customer relationships.** Customers who are provided access to timely information about product availability, specifications and cost increase their efficiency. In business-to-business relationships, the more timely and accurate information

a business makes available to their customers, the more likely they are to retain that business. Collaborate with other companies on joint development efforts

- **Reduced margin of error.** An extranet can reduce a company's margin of error thereby reducing or eliminating costly errors, especially with something as complex as processing orders from distributors and suppliers. Customers can be given access to their accounts to verify order history, account balances and payments.
- **Timely and accurate information.** On an extranet a business can instantly change, edit, and update sensitive information such as price lists or inventory information. Compared to typical paper-based publishing processes, an extranet offers a unique opportunity to quickly get information into the right hands before it's out-of-date.
- **Reduced inventory.** One of the greatest advantage of a business-to-business extranet is its impact on supply-chain management. By linking the inventory system directly to a supplier, businesses can process orders as soon as the system knows they are needed, thus reducing the stock a business keeps on hand and generally making the procurement process more efficient.
- **Flexibly.** A well designed extranet allows remote and mobile staff to access core business information 24 hours a day, irrespective of location. This allows employees to work remotely or respond to critical requests for information after normal working hours. As businesses expand globally, the ability to work across time zones is enhanced by the establishment of an extranet.

practice question 17.4.2

What is the primary difference between how businesses use intranets versus extranets?

a. Intranets are secret networks used only by insiders while extranets are wide-open to the public
b. Intranets are networks for the use of internal employees only, while extranets allow customers and partners access to the network
c. Intranets utilize LAN and WAN technology while extranets only use LAN technology.
d. Businesses use both intranets and extranets to develop information about their competitors.

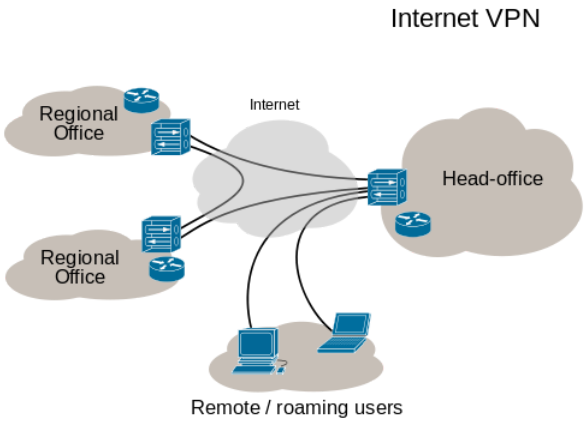
Answer

b. The primary difference between intranets and extranets is who has access to the network.

Whether a company is managing an intranet or extranet, both systems can raise security issues. With increased access comes an increased opportunity for security breaches. In particular, the security of extranets can be a concern when hosting valuable or proprietary information. Unless sufficient security precautions are taken, data can be breached and altered, without either the sender or the receiver being aware of the interception. The growth in the complexity of networks has increased the possible points of attack, both from within organizations and from outside the company. Fortunately, the means of protecting against hackers have also expanded in line with the technology.

Virtual Private Networks (VPNs)

A **virtual private network (VPN)** extends a private network (intranet) across a public network Internet), and enables users to send and receive data across shared or public networks as if their computing devices were directly connected to the private network. Applications running across a VPN may therefore benefit from the functionality, security, and management of the private network while taking advantage of the flexibility of the Internet. In a business setting, remote-access VPNs allow employees to access their company's intranet from home or while traveling outside the office. Site-to-site VPNs allow employees in geographically separated offices to share one cohesive virtual network.



To ensure security, the VPN connection is established using encryption protocols and VPN users use authentication methods, including passwords or certificates, to gain access to the VPN.

Although VPNs cannot make online connections completely secure, they can increase privacy and security. For example, to prevent disclosure of private information, VPNs typically allow only authenticated remote access using encryption techniques.

Some of the security advantages of a VPN include the following:

- even if the network traffic is accessed, an attacker would see only encrypted data
- sender authentication is required to prevent unauthorized users from accessing the VPN
- the VPN messaging is designed to detect instances of tampering with transmitted messages

As security concerns continue to grow in the digital age, more and more companies are emerging to serve the growing demand for VPN services. Which service a business chooses will be determined by its planned uses for the VPN.

practice question 17.4.3

How do businesses utilize Virtual Private Networks (VPN) to manage information?

a. VPNs provide Video Protected Networks to allow companies to host video conferences world-wide
b. VPNs provide remote server backups and archives to protect company data
c. VPNs provide external secure access to internal networks via the internet so that remote users can be productive despite geographical location.
d. VPNs block external access to sensitive internal networks in order to guarantee information safety.

Answer

d. VPNs provide both access and security across multiple locations.

1. McGovern, Gerry (November 18, 2002). "Intranet return on investment case studies".. Retrieved 2018-11-03 ↵

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17.5: Current Issues in IT

What you'll learn to do: Identify security, privacy and ethical issues affected by information technology

Now that we have acknowledged the amount of data that business collects about people, what are the risks and challenges associated with keeping that information secure? Businesses stand to lose consumer confidence and respect if they allow unauthorized access to customer data. For this reason, businesses take information security and cyber-security seriously. Despite the importance of protecting customer data, breaches and hacks seem to be more and more common. Is this a result of inadequate security measures on the part of the businesses, or are hackers getting better at accessing so-called "secure networks"? The answer is probably both. In this section you'll learn about some of the ongoing security issues businesses face in trying to safeguard their (and their customers') electronic communications and data.

Learning Objectives

- Identify privacy issues associated with information technology
- Identify ethical issues associated with information technology

Security Issues in Information Technology

Now that we have acknowledged the amount of data that business collects about people, what are the risks and challenges associated with keeping that information secure? Businesses stand to lose consumer confidence and respect if they allow unauthorized access to customer data. For this reason, businesses take information security and cyber-security seriously. Despite the importance of protecting customer data, breaches and hacks seem to be more and more common. Is this a result of inadequate security measures on the part of the businesses, or are hackers getting better at accessing so-called "secure networks"? The answer is probably both. In this section you'll learn about some of the ongoing security issues businesses face in trying to safeguard their (and their customers') electronic communications and data.

Information technology has presented businesses with opportunities undreamt of only a couple of decades ago. But it also has introduced some unprecedented challenges.

It has been estimated that businesses expend more than 5% of their annual IT budgets protecting themselves against disrupted operations and theft due to information theft . A February 2018 report by McAfee estimates that cyber-crime costs the world over $800 billion or 0.08% of global GDP. Among the reasons given for the growing cost of cyber-crime are:

- Quick adoption of new technologies by cyber-criminals
- The increased number of new users online (these tend to be from low-income countries with weak cyber-security)
- The increased ease of committing cyber-crime, with the growth of Cyber-crime-as-a-Service
- An expanding number of cyber-crime "centers" that now include Brazil, India, North Korea, and Vietnam
- A growing financial sophistication among top-tier cyber criminals that, among other things, makes monetization easier

According to the McAfee report, "Monetization of stolen data, which has always been a problem for cyber-criminals, seems to have become
less difficult because of improvements in cyber-crime black markets and the use of digital currencies[1]."

Cyber-crime can take on many faces from data breaches to malicious program that attack a company's network and disrupt service or corrupt sensitive corporate data. We will examine just a few of the ways that criminals are using technology to wreak havoc on business operations.

Viruses and Malicious Programs

With the increased use of the Internet comes an increased risk of a business's computer network being effected by malicious programs such as viruses. A computer virus is a piece of computer code that is inserted into another program and lies dormant until triggered by an unsuspecting user. This trigger can be as simple as opening a file attachment or downloading a file from the Internet. Viruses range from the playful, simply displaying an image on the users' screen meant to be funny to extreme cases where data files are permanently erased. Most companies deploy anti-virus software across their network, but even the most sophisticated anti-virus software cannot keep up with the ever growing number of viruses and malicious programs out there. Motives for creating viruses can include seeking profit (e.g., with ransomware), desire to send a political message, personal amusement, to demonstrate that a vulnerability exists in software, for sabotage and denial of service, or simply because hackers wish to explore cyber-security issues. The consequences of such viruses and malicious programs can be catastrophic, effectively destroying a company's entire network and electronic records.

Phishing

One of the most prevalent cyber-attacks is the phishing scam. Phishing is when a scammer uses fraudulent emails or texts, or copycat websites to get you to share valuable personal information – such as account numbers, Social Security numbers, or your login IDs and passwords. Scammers use your information to steal your money or your identity or both. Scammers also use phishing emails to get access to your computer or network then they install programs like ransomware that can lock you out of important files on your computer.

Phishing scammers lure their targets into a false sense of security by spoofing the familiar, trusted logos of established, legitimate companies. Or they pretend to be a friend or family member. Phishing scammers make it seem like they need your information or someone else's, quickly – or something bad will happen. They might say your account will be frozen, you'll fail to get a tax refund, your boss will get mad, even that a family member will be hurt or you could be arrested. They tell lies to get to you to give them information.

To protect yourself and your company's information, the U.S. Federal Trade Commission recommends the following precautions:

- **Be cautious about opening attachments or clicking on links in emails**. Even your friend or family members' accounts could be hacked. Files and links can contain malware that can weaken your computer's security.
- **Do your own typing**. If a company or organization you know sends you a link or phone number, don't click. Use your favorite search engine to look up the website or phone number yourself. Even though a link or phone number in an email may look like the real deal, scammers can hide the true destination.
- **Make the call if you're not sure.** Do not respond to any emails that request personal or financial information. Phishers use pressure tactics and prey on fear. If you think a company, friend or family member really does need personal information from you, pick up the phone and call them yourself using the number on their website or in your address book, not the one in the email.
- **Turn on two-factor authentication**. For accounts that support it, two-factor authentication requires both your password and an additional piece of information to log in to your account. The second piece could be a code sent to your phone, or a random number generated by an app or a token. This protects your account even if your password is compromised.

- **Back up your files to an external hard drive or cloud storage.** Back up your files regularly to protect yourself against viruses or a ransomware attack.
- **Keep your security up to date**. Use security software you trust, and make sure you set it to update automatically.

Even with these precautions in place, highly sophisticated phishing scams are successful in achieving their goal. The following 2018 statistics from Dashlane **(SOURCE: https://blog.dashlane.com/phishing-statistics/)** illustrate just how prolific phishing attacks are:

- According to PhishMe's Enterprise Phishing Resiliency and Defense Report, phishing attempts have grown 65% in the last year.
- According to Wombat Security State of the Phish, 76% of businesses reported being a victim of a phishing attack in the last year.
- According to the Verizon Data Breach Investigations Report, 30% of phishing messages get opened by targeted users and 12% of those users click on the malicious attachment or link.
- According to the SANS Institute, 95% of all attacks on enterprise networks are the result of successful spear phishing.
- According to Symantec, phishing rates have increased across most industries and organization sizes — no company or vertical is immune.
- According to the Webroot Threat Report, nearly 1.5 million new phishing sites are created each month.

Another way that cyber-criminals interrupt business operations is through DoS (Denial of Service attacks).

Denial of Service

A denial-of-service (DoS) attack occurs when legitimate users are unable to access information systems, devices, or other network resources due to the actions of a malicious cyber threat actor. Services affected may include email, websites, online accounts (e.g., banking), or other services that rely on the affected computer or network. A denial-of-service is accomplished by flooding the targeted host or network with traffic until the target cannot respond or simply crashes, preventing access for legitimate users. DoS attacks can cost an organization both time and money while their resources and services are inaccessible. In 2012, not one, not two, but a whopping six U.S. banks were targeted by a string of DoS attacks. The victims were no small-town banks either: They included Bank of America, JP Morgan Chase, U.S. Bancorp, Citigroup and PNC Bank.

These are just a few of the security issues associated with information technology. Such risks illustrate the need for increased cybersecurity to protect computer systems from theft or damage to their hardware, software or electronic data, as well as from disruption or misdirection of the services they provide. The field is of growing importance due to increasing reliance on computer systems, the Internet and wireless networks such as Bluetooth and Wi–Fi, and due to the growth of "smart" devices, including smartphones, televisions and the various devices that constitute the Internet of Things. Due to its complexity, both in terms of politics and technology, it is one of the major challenges of the contemporary world.

practice question 17.5.1

The following are information security issues EXCEPT:

a. Phishing
b. Cyber currency
c. Viruses and malicious programs
d. Denial of Service

Answer

b. Although there are issues associated with cyber currency, it is not itself an information security issue.

Ethical and Social Issues in Information Technology

As you'll recall, the industrial revolution of the nineteenth century gave rise to a number of unforeseen ethical and social issues—for instance, concerns about workplace safety, wages, discrimination, and child labor—which led to real changes in worker protections, labor practices, and law. Similarly, the technology revolution of the twentieth century—starting with the widespread use of the Internet and home computers—has spawned a new set of ethical and social concerns that people a hundred years ago couldn't have imagined: for example, how should personal information and online privacy be protected? Who gets to own the

information about our habits and “likes”? Before the advent of the Internet, people thought about and controlled their personal information in very different ways. Today, many of us lead complex online lives, and we may not even realize how our personal information is being collected and used. Companies like Caesars can collect data on the purchasing patterns, personal preferences, and professional/social affiliations of their customers without their even knowing about it. In this section we’ll explore some of the ethical and social issues related to network security, privacy, and data collection that businesses must address.

Technoethics

Ethical and social issues arising from the use of technology in all areas of our lives—and in business, in particular—have lead to the creation of a new branch of ethics: technoethics.

Technoethics (TE) is an interdisciplinary research area concerned with all moral and ethical aspects of technology in society. It draws on theories and methods from multiple knowledge domains (such as communications, social sciences information studies, technology studies, applied ethics, and philosophy) to provide insights on ethical dimensions of technological systems and practices for advancing a technological society.[2]

Technoethics views technology and ethics as socially embedded enterprises and focuses on discovering the ethical use of technology, protecting against the misuse of technology, and devising common principles to guide new advances in technological development and application to benefit society. Typically, scholars in technoethics have a tendency to conceptualize technology and ethics as interconnected and embedded in life and society. Technoethics denotes a broad range of ethical issues revolving around technology- from specific areas of focus affecting professionals working with technology to broader social, ethical, and legal issues concerning the role of technology in society and everyday life.[3]

Recent advances in technology and their ability to transmit vast amounts of information in a short amount of time has changed the way information is being shared amongst co-workers and managers throughout organizations across the globe. Starting in the 1980s with information and communications technologies (ICTs), organizations have seen an increase in the amount of technology that they rely on to communicate within and outside of the workplace. However, these implementations of technology in the workplace create various ethical concerns and in turn a need for further analysis of technology in organizations. As a result of this growing trend, a subsection of technoethics known as organizational technoethics has emerged to address these issues.

Technoethical perspectives are constantly changing as technology advances into areas unseen by creators and users engage with technology in new ways.

Technology, Business, and Your Data

Technology makes businesses more efficient, makes tasks faster and easier to complete, and ultimately creates value from raw data. However, as much as technology impacts the *way* that companies do business, it also raises important new issues about the employer-employee relationship. If you send personal emails from your office computer, do you have the right to expect that they’re private? Does your employer have a legal and ethical right to “cyber-peek” at what you are doing with company assets? Twenty years ago this was not an issue; today it’s a case before the Supreme Court.

Social Media

Employers want to use technology to help them screen applicants and verify information about their workforce, which is understandable. In the module on Human Resource Management you learned about the cost of recruiting, hiring, and training employees. However, what if the company believes that one of the quickest ways to gather information about an employee is to access their social media accounts? A company would never ask for your login credentials for Facebook, Twitter, InstaGram, LinkdIn . . . or would they? And if they did, is it legally and ethically justified? What would you do if you found yourself in the situation presented in the following video?

Information As a Business

The fact is that technology has put our information at the fingertips of businesses—there for the taking and, in some cases, the selling. Is it ethical for a business to collect data about a person and then sell that information to another business? Many organizations collect data for their own purposes, but they also realize that your data has value to others. As a result, selling data has become an income stream for many organizations. If you didn't realize that your data was collected by Company A, it's even less likely you knew that it was sold to Company B.

We have discussed just a few of the emerging ethical issues surrounding business, technology, and personal data. We have yet to touch on security issues and the responsibility business has to protect your data once it has been collected.

practice question 17.5.2

Name the area where information technology in the workplace can affect personal privacy:

a. Food items left in the break room refrigerators
b. Photos or personal effects left in company cubicles
c. Emails or messages sent on company-owned devices
d. Mileage accrued on company vehicles

Answer

c. Emails or text messages using company owned devices are not the private property of the employee.

practice question 17.5.3

Citing company's "cyber-peeking" at employee communications, businesses accessing social media accounts to get information on an individual, or businesses buying and selling consumer personal data to each other, what conclusions can be drawn about the benefits and challenges in information technology today?

a. Advances in IT have made companies more efficient but have raised consumer prices.
b. Advances in IT have helped companies better satisfy consumer needs but at the cost of individual privacy
c. Advances in IT have helped companies become more competitive and better able to meet regulatory constraints.
d. Advances in IT have helped organizations become more productive but less attuned to the needs of their customers.

Answer

b. We only need to look at how we live today to see the benefits of IT, but if we look a little deeper we see that there is a price to pay.

1. csis-prod.s3.amazonaws.com/s3fs-public/publication/economic-impact-cybercrime.pdf?kab1HywrewRzH17N9wuE24soo1IdhuHdutm_source=Pressutm_campaign=bb9303ae70-EMAIL_CAMPAIGN_2018_02_21utm_medium=emailutm_term=0_7623d157be-bb9303ae70-194093869 ↵
2. Luppicini, R. (2010). Technoethics and the evolving knowledge society. Hershey: Idea Group Publishing. ↵
3. Luppicini, R. (2010). Technoethics and the evolving knowledge society. Hershey: Idea Group Publishing. ↵

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17.6: Putting It Together- Using Technology to Manage Business Information

Summary

In this module you learned about the roles of data and information technology in business operations. Following is a summary of the key points we covered.

Data vs. Information

Technology has made it easy for businesses to gather facts about their customers and business operations. However, data are just facts and figures in their raw form. It's not until the data are processed—i.e., converted into information—that businesses can use them to improve their operations.

Managing Data

Being able to collect data is central to most businesses; however, all that data needs to be stored somewhere so users can retrieve it and use it. The creation of databases—virtual warehouses where data is stored—allows businesses to take the first step in managing and using data. Since the creation of "cloud computing," businesses have been able to store their data offsite but still access it from anywhere in the world. Businesses mine data in order to find valuable patterns and answers to questions.

Information in Networks

In order to make the greatest use of data, it must be shared. In business this means that data collected by marketing needs to be shared with other departments—finance, production, research, and development—via networks. Again, this is where businesses must make decisions about the best way to share data: through internal networks (LANS), wide-area networks, (WANS) or the cloud. Each has its own set of advantages and disadvantages.

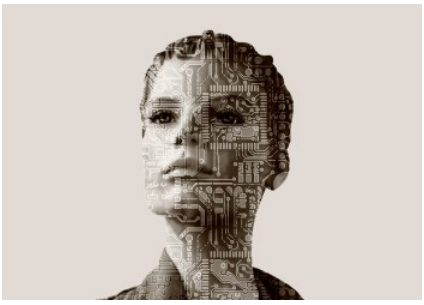
Ethical and Social Issues

Who owns your information? This question is at the heart of many of the ethical and social issues that arise when businesses collect data. The debate about how best to balance the benefits of information technology with the costs to personal privacy has led to a new field of study called technoethics.

Information Security and Cybersecurity

With big data comes big responsibility. This responsibility is about keeping customer and employee data safe from the threat of cyber criminals and illicit users. Large data security breaches have become more prevalent in recent years, and businesses are constantly working to find better and more effective ways to protect their data.

Synthesis



Each of us can be represents by hundreds of data points about our daily activities, our likes and dislikes, shopping habits, income, zip code, mobile phone use, age, gender, marital status, and so on—the list is nearly endless. We are in many respects the sum of the data collected about us. How businesses use that information will continue to evolve as technology changes. It's clear, though, that collecting, storing, managing, and using our data are vital components of virtually all business operations. The issues associated with the use of data and information technology are evolving just as quickly. Society now finds itself torn between the benefits that data can provide and the toll it takes on individual privacy. Most people believe that the organizations collecting our data have a responsibility to protect it against unauthorized access and use. Regardless of whether you pursue a career in business or not, the topics you learned about in this module will apply to you as a citizen, an employee, and an individual. As technology and data collection methods become ever more sophisticated and complex, the burden is on all of us—consumers and businesses alike—to devise effective ways of managing and controlling them.

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CHAPTER OVERVIEW

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18.1: "Salty Pawz" Background

Several years ago, Wanda went to the local animal shelter looking for a new dog, and when she arrived, the most pathetic looking bulldog-boxer mix she had ever encountered greeted her. The puppy had terrible skin problems, had lost almost all of his fur and his skin was pink from scratching. The poor thing looked like a naked mole rat, but Wanda fell in love with him at first sight. She didn't look any further than that first kennel and promptly filled out the paperwork, named him Cosmo and took him to the vet. Her vet was cautiously optimistic about Cosmo's prospects for recovery but advised Wanda that in addition to medication, Wanda would have to be very careful about what she fed Cosmo. As a result, Wanda began to research dog food and was horrified at the low quality of the foods and treats available. She began to research healthier alternatives and after some experimentation, developed several recipes for treats that Cosmo could eat without any ill side effects. As her friends watched the evolution of Cosmo from sickly pup to happy dog, they began to ask Wanda to bake those treats for their dogs as well. Soon, friends of friends were calling her for treats and before she knew it, Wanda was in the gourmet dog treat business.

As a result of this blossoming interest in what she was doing, Wanda has been successfully baking and selling dog treats out of her home for the past several years, using the product name of "Salty Pawz." The demand for her custom dog treats has grown to the point that she has a couple of friends who help her on a regular basis. Several months ago, she began selling her treats on Etsy.com. Since then, her online orders have started to outpace her capacity. This month, her brother-in-law set up a website for Salty Pawz and at first was excited that more people would have access to her products, but did not anticipate how many orders it would generate.

She has been talking to entrepreneurs in her hometown to get advice about taking her operation "to the next level." She has questions and concerns about almost every aspect of business – finances, legal structure, marketing, production and overall strategy: Does she even want to grow Salty Pawz further? And if so, how would she grow it successfully?

General Information about "Salty Pawz"

- The business was established in 2010 as a sole proprietorship. Wanda has been claiming all of the income and expenses for her business on a Schedule C of her personal income tax return. She uses a CPA to prepare her taxes, but maintains the day-to-day bookkeeping herself. Salty Pawz has shown a profit since 2011.
- Salty Pawz currently operates out of Wanda's home in North Carolina, and has had her kitchen certified by the local health department as a commercial kitchen.
- She does not currently need a business license because all of her product is shipped and she has no customers coming to her home.
- Salty Pawz does have a Federal Employer Identification number for tax withholding purposes, a NC Sales Tax identification number and is registered with the NC Employment Security Commission for the purposes of reporting NC Unemployment Insurance Tax.
- Two of Wanda's friends help her on a part-time basis, primarily at night and on weekends after their regular jobs. She pays them in dog treats and is not currently paying salaries or wages.
- Wanda's brother-in-law manages her website, posting information about her products and keeping the information on the company current. He doesn't charge her anything, but she feels badly asking him to do too much work for "free."
- Wanda spends most nights answering emails and inquiries through Etsy and her website while her friends bake and package the treats. She is working 15-hour days, 7 days a week and knows she can't keep this pace up much longer. She is very reluctant to change how she is doing business because she doesn't want to give up on the success she has built.
- She is using the local "Pack & Ship" to get her dog treats to her customers, but sometimes she finds herself running to Pack & Ship more than once a day. She is trying to figure out a better way to handle shipping but hasn't made any decisions about what would be best.

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18.2: Salty Pawz Marketing

Products:

Wanda sells three varieties of dog treats: Chicken Cuties, Bison Bites and Lamb Lovies. Each treat comes in a plastic pouch containing 12 treats. She has the following assortments available:

- Party Pooch = 4 each of 3 flavors
- Chicken Cuties= 12 Chicken
- Bison Bites = 12 Bison
- Lamb Lovies = 12 Lamb

Salty Pawz Commitment to Healthy Dogs

Since the very beginning, Wanda has been committed to providing a healthy alternative to mass produced dog treats. Consequently, she has been very careful about sourcing her ingredients. The chicken she uses in the Chicken Cuties is from free-range chickens that are fed no artificial growth hormones or antibiotics. It took her a while, but she was able to find several ranchers who raise lamb and bison in an environment where they are fed only non-GMO grains. She does not add preservatives, dyes or fillers to her treats.

Pricing:

Wanda has priced her treats on what would be considered the “high” end of the market. She determined her price based on her costs and what she wants to earn every month. Although she pays attention to what other businesses are charging, she has never conducted any research to determine how she stacks up against the competition. She is selling as many treats as she and her friends can make, so price is not something she is concerned about at this time.

Place:

Salty Pawz products are sold via the Internet and all of Wanda’s business is conducted through some form of e-commerce. She has her treats listed on www.etsy.com where they are one of a large variety of treats available. Her brother-in-law recently launched her website using Webley and she is still getting used to managing the site. In reality, when she gets a “sale” through her website she is sending the customers to etsy to complete the purchase. When she told Jim this he asked her “aren’t you afraid that when your customers get to etsy they will find someone else’s treats and buy them instead?” Wanda just scratched her head.

Promotion:

Salty Pawz does not have marketing materials, does no promotions or advertising. Wanda thinks it might be a good idea, but currently she relies on word of mouth to advertise her business. She has business cards she purchased from an online service and encloses one with each order. Jamie dropped some off at the local veterinarian’s office a few months ago, but no one has checked to see if they are still there.

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18.3: Salty Pawz Financial Information

Sales + Revenue: For the last 6 months, Wanda's sales have broken down as shown below. She has also provided you with her cost for each variety of treat.

Products/Services	% of Sales	Sales Price	COGS	Contribution	Profit Margin	Weighted Profit Margin
Party Pooch	45%	20.00	10.40	9.60	48.00%	21.60%
Chicken Cuties	18%	15.00	7.80	7.20	48.00%	8.64%
Bison Bites	5%	21.00	10.80	10.20	48.57%	2.43%
Lamb Lovies	32%	24.00	12.60	11.40	47.50%	15.20%
total	100%		Average profit margin:			47.87%

	Sales Price	COGS
Chicken Cutlets	1.25	0.65
Bison Bites	1.75	0.90
Lamb Lovies	2.00	1.05

Cost of Goods Sold. Wanda's COGS include the packaging, labeling, the ingredients, and the time it takes to make the treats. Since she can bake them in big batches, her labor cost per unit is very low.

When Wanda ships her products, she charges just what it costs her. Shipping is done on a cost recovery basis and currently she doesn't consider it in her income/expenses.

Monthly Expenses. Currently Wanda's monthly expenses are:

Rent	0.00
Electricity	0.00
Telephone	100.00
Water /Sewer	0.00
Internet	60.00
Website	175.00
Salaries	0.00
Owner's Draw	1000.00
Office Supplies	50.00
Loan Payment	0.00
Insurance	85.00
Other	0.00
Total Overhead	$1,470.00

Sales Mix:

Currently Wanda's customers purchase her products at the following ratios:

Products/Services	% of Sales
Party Pooch	45%
Chicken Cuties	18%

Bison Bites	5%
Lamb Lovies	32%

Break Even Calculation. Based on her current monthly expenses and sales mix, this is what Wanda has to sell in order to break-even:

Products/Services	% of Sales	Sales Price	COGS	Contribution	Profit Margin	Weighted Profit Marg.
Party Pooch	45%	20.00	10.40	9.60	48.00%	21.60%
Chicken Cuties	18%	15.00	7.80	7.20	48.00%	8.64%
Bison Bites	5%	21.00	10.80	10.20	48.57%	2.43%
Lamb Lovies	32%	24.00	12.60	11.40	47.50%	15.20%
Total: (Must equal 100%)	100%		Average profit margin:			47.87%

$$\frac{Total\ Overhead}{Average\ Profit\ Margin} = BREAKEVEN$$

$$\frac{\$1{,}470.00}{47.87\%} = \$3.070.91$$

Average Sales per Customer: $20.00

	Breakeven	Party Pooch	Chicken Cuties	Bison Bites	Lamb Lovies
Monthly in Dollars	$3,070.91	$1,381.91	$552.76	$153.55	$982.69
In Units		69	37	7	41

Forecasting Supply and Demand. Wanda is at capacity for production out of her kitchen, so she believes that she is at the maximum income she can generate with her current structure. If Wanda changes her pricing structure, the following quantities demanded and quantities supplied will result.

Chicken Cuties	
Price ($)	Demand (Q)
$0.75	1000
$1.00	900
$1.25	800
$1.50	700
$1.75	600
$2.00	500

Chicken Cuties	
Price ($)	Supply (Q)
$0.75	500
$1.00	650
$1.25	800
$1.50	1000
$1.75	1400
$2.00	1500

Chicken Cuties		
Price ($)	Demand (Q)	Supply (Q)
$0.75	1000	500
$1.00	900	650
$1.25	800	800
$1.50	700	1000
$1.75	600	1400
$2.00	500	1500

Bison Bites	
Price ($)	Demand (Q)
$1.00	1200
$1.25	1100
$1.50	900
$1.75	800
$2.00	700
$2.25	400

Bison Bites	
Price ($)	Supply (Q)
$1.00	500
$1.25	600
$1.50	700
$1.75	900
$2.00	1000
$2.25	1400

Bison Bites		
Price ($)	Demand (Q)	Supply (Q)
$1.00	1200	500
$1.25	1100	600
$1.50	900	700
$1.75	800	900
$2.00	700	1000
$2.25	400	1400

Lamb Lovies	
Price ($)	Demand (Q)
$1.75	1500
$2.00	1400
$2.25	1200
$2.50	1000
$2.75	800
$3.00	700

Lamb Lovies	
Price ($)	Supply (Q)
$1.75	800
$2.00	900
$2.25	1000
$2.50	1200
$2.75	1400
$3.00	1600

Lamb Lovies		
Price ($)	Demand (Q)	Supply (Q)
$1.75	1500	800
$2.00	1400	900
$2.25	1200	1000
$2.50	1000	1200
$2.75	800	1400
$3.00	700	1600

Party Pooch	
Price ($)	Demand (Q)
$16.00	1400
$18.00	1200
$20.00	1100
$22.00	1000
$24.00	900
$26.00	800

Party Pooch	
Price ($)	Supply (Q)
$16.00	600
$18.00	700
$20.00	800
$22.00	1000
$24.00	1200
$26.00	1400

Party Pooch		
Price ($)	Demand (Q)	Supply (Q)
$16.00	1400	600
$18.00	1200	700
$20.00	1100	800
$22.00	1000	1000
$24.00	900	1200
$26.00	800	1400

Income Information. Here is a summary of Wanda's Salty Pawz income information for the past 6 months.

INCOME:	
Party Pooch	$ 40,500.00
Chicken Cuties	$ 16,200.00
Bison Bites	$ 4,515.00
Lamb Lovies	$ 28,800.00
TOTAL INCOME:	$ 90,015.00
COST OF GOODS SOLD:	
Party Pooch	$ 21,060.00
Chicken Cuties	$ 8,424.00
Bison Bites	$ 4,515.00
Canine Craving	$ 15,120.00
Total cost of sales	$ 49,119.00
GROSS PROFIT	$ 40,896.00
OPERATING EXPENSES:	
Rent	$ -
Electricity	$ -
Telephone	$ 600.00
Water /Sewer	$ -
Internet	$ 360.00
Website	$ 1,050.00
Salaries	$ -
Owner's Draw	$ 6,000.00
Office Supplies	$ 300.00
Loan Payment	$ -
Insurance	$ 510.00
Other	$ -
TOTAL EXPENSES	$ 8,820.00
NET INCOME BEFORE TAXES	$ 32,076.00

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18.4: "Salty Pawz"- A Case Study in Business

Throughout the course, you will interact with Wanda, the founder and owner of Salty Pawz, a small business that specializes in preparing and selling high-quality gourmet dog treats. Like many entrepreneurs, Wanda has a great deal of experience and expertise in the specific products she produces, but she knows little about the broader business environment. As a student of business, you will find that Wanda will need your help and ask your advice throughout this course. The information contained in this case study is taken from Wanda's business operations, and you'll need it it in order to apply the concepts and theories in this course—and to help her.

You can read the case study information on the following pages or download it as a Microsoft Word document here: https://s3-us-west-2.amazonaws.com/oerfiles/WMBusiness/SaltyPawzCaseStudy.docx

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