

Exploring Business

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Chapter 1 The Foundations of Business

Getting Down to Business

Learning Objective

1. Identify the main participants of business, the functions that most businesses perform, and the external forces that influence business activities.

A business is any activity that provides goods or services to consumers for the purpose of making a profit. When Steve Jobs and Steve Wozniak created Apple Computer in Jobs' family garage, they started a business. The product was the Apple I, and the company's founders hoped to sell their computers to customers for more than it cost to make and market them. If they were successful (which they were), they'd make a profit. Before we go on, let's make a couple of important distinctions concerning the terms in our definitions. First, whereas Apple produces and sells *goods* (Mac, iPhone, iPod, iPad), many businesses provide *services*. Your bank is a service company, as is your Internet provider. Hotels, airlines, law firms, movie theaters, and hospitals are also service companies. Many companies provide both goods and services. For example, your local car dealership sells goods (cars) and also provides services (automobile repairs).

Second, some organizations are not set up to make profits. Many are established to provide social or educational services. Such not-for profit (or nonprofit organizations include the United Way of America, Habitat for Humanity, the Boys and Girls Clubs, the Sierra Club, the American Red Cross, and many colleges and universities. Most of these organizations, however, function in much the same way as a business. They establish goals and work to meet them in an effective, efficient manner. Thus, most of the business principles introduced in this text also apply to nonprofits.

Business Participants and Activities

Let's begin our discussion of business by identifying the main participants of business and the functions that most businesses perform. Then we'll finish this section by discussing the

external factors that influence a business's activities.

Participants

Every business must have one or more *owners* whose primary role is to invest money in the business. When a business is being started, it's generally the owners who polish the business idea and bring together the resources (money and people) needed to turn the idea into a business. The owners also hire *employees* to work for the company and help it reach its goals. Owners and employees depend on a third group of participants—*customers*. Ultimately, the goal of any business is to satisfy the needs of its customers in order to generate a profit for the owners.

Functional Areas of Business

The activities needed to operate a business can be divided into a number of *functional areas*: management, operations, marketing, accounting, and finance. Let's briefly explore each of these areas.

Management

Managers are responsible for the work performance of other people. Management involves planning for, organizing, staffing, directing, and controlling a company's resources so that it can achieve its goals. Managers *plan* by setting goals and developing strategies for achieving them. They *organize* activities and resources to ensure that company goals are met. They *staff* the organization with qualified employees and *direct* them to accomplish organizational goals. Finally, managers design *controls* for assessing the success of plans and decisions and take corrective action when needed.

Operations

All companies must convert resources (labor, materials, money, information, and so forth) into goods or services. Some companies, such as Apple, convert resources into *tangible* products—Macs, iPhones, iPods, iPads. Others, such as hospitals, convert resources into *intangible* products—health care. The person who designs and oversees the transformation of resources into goods or services is called an operations manager. This individual is also responsible for ensuring that products are of high quality.

Marketing

Marketing consists of everything that a company does to identify customers' needs and

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designs products to meet those needs. Marketers develop the benefits and features of products, including price and quality. They also decide on the best method of delivering products and the best means of promoting them to attract and keep customers. They manage relationships with customers and make them aware of the organization's desire and ability to satisfy their needs.

Accounting

Managers need accurate, relevant, timely financial information, and accountants provide it. Accountants measure, summarize, and communicate financial and managerial information and advise other managers on financial matters. There are two fields of accounting. *Financial accountants* prepare financial statements to help users, both inside and outside the organization, assess the financial strength of the company. *Managerial accountants* prepare information, such as reports on the cost of materials used in the production process, for internal use only.

Finance

Finance involves planning for, obtaining, and managing a company's funds. Finance managers address

such questions as the following: How much money does the company need? How and where will it get the necessary money? How and when will it pay the money back? What should it do with its funds? What investments should be made in plant and equipment? How much should be spent on

research and development? How should excess funds be invested? Good financial

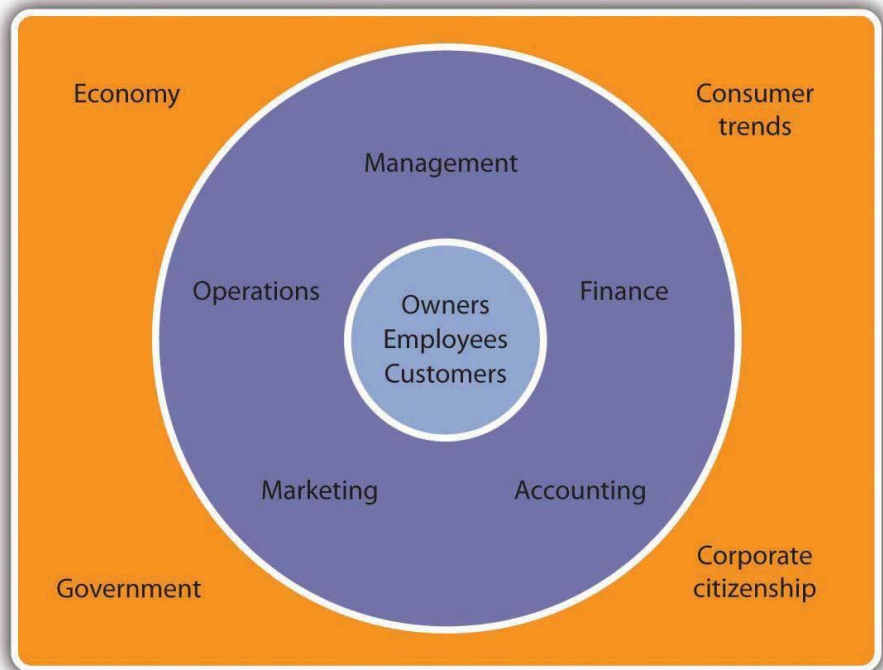


Figure 1 Business and Its Environment

management is particularly important when a company is first formed, because new business owners usually need to borrow money to get started.

External Forces that Influence Business Activities

Apple and other businesses don't operate in a vacuum: they're influenced by a number of external factors. These include the economy, government, consumer trends, and public pressure to act as good corporate citizens. Figure 1 "Business and Its Environment" sums up the relationship among the participants in a business, its functional areas, and the external forces that influence its activities. One industry that's clearly affected by all these factors is the fast-food industry. A strong *economy* means people have more money to eat out at places where food standards are monitored by a *government* agency, the Food and Drug Administration. Preferences for certain types of foods are influenced by *consumer trends* (eating fried foods might be OK one year and out the next). Finally, a number of decisions made by the industry result from its *desire to be a good corporate citizen*. For example, several fast-food chains have responded to environmental concerns by eliminating Styrofoam containers.¹ As you move through this text, you'll learn more about these external influences on business. (Section 1.3 "What Is Economics?" will introduce in detail one of these external factors—the economy.)

Key Takeaways

- The main participants in a business are its owners, employees, and customers.
- Businesses are influenced by such external factors as the economy, government, consumer trends, and public pressure to act as good corporate citizens.
- The activities needed to run a business can be divided into five functional areas:
 1. **Management** involves planning, organizing, staffing, directing, and controlling resources to achieve organizational goals.
 2. **Operations** transforms resources (labor, materials, money, and so on) into products.
 3. **Marketing** works to identify and satisfy customers' needs.

4. **Finance** involves planning for, obtaining, and managing company funds.
5. **Accounting** entails measuring, summarizing, and communicating financial and managerial information.

What Is Economics?

Learning Objectives

1. Define economics and identify factors of production.
2. Explain how economists answer the three key economics questions.
3. Compare and contrast economic systems.

To appreciate how a business functions, we need to know something about the economic environment in which it operates. We begin with a definition of economics and a discussion of the resources used to produce goods and services.

Resources: Inputs and Outputs

Economics is the study of the production, distribution, and consumption of goods and services. Resources are the *inputs* used to produce *outputs*. Resources may include any or all of the following:

- Land and other natural resources
- Labor (physical and mental)
- Capital, including buildings and equipment
- Entrepreneurship

Resources are combined to produce goods and services. Land and natural resources provide the needed raw materials. Labor transforms raw materials into goods and services. Capital (equipment, buildings, vehicles, cash, and so forth) are needed for the production process. Entrepreneurship provides the skill and creativity needed to bring the other resources together to produce a good or service to be sold to the marketplace.

Because a business uses resources to *produce* things, we also call these resources factors of production. The factors of production used to produce a shirt would include the following:

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- The land that the shirt factory sits on, the electricity used to run the plant, and the raw cotton from which the shirts are made
- The laborers who make the shirts
- The factory and equipment used in the manufacturing process, as well as the money needed to operate the factory
- The entrepreneurship skill used to coordinate the other resources to initiate the production process and the distribution of the goods or services to the marketplace.

Input and Output Markets

Many of the factors of production (or resources) are provided to businesses by households. For example, households provide businesses with labor (as workers), land and buildings (as landlords), and capital (as investors). In turn, businesses pay households for these resources by providing them with income, such as wages, rent, and interest. The resources obtained from households are then used by businesses to produce goods and services, which are sold to the same households that provide businesses with revenue. The revenue obtained by businesses is then used to buy additional resources, and the cycle continues. This circular flow is described in Figure 2 "The Circular Flow of Inputs and Outputs", which illustrates the dual roles of households and businesses:

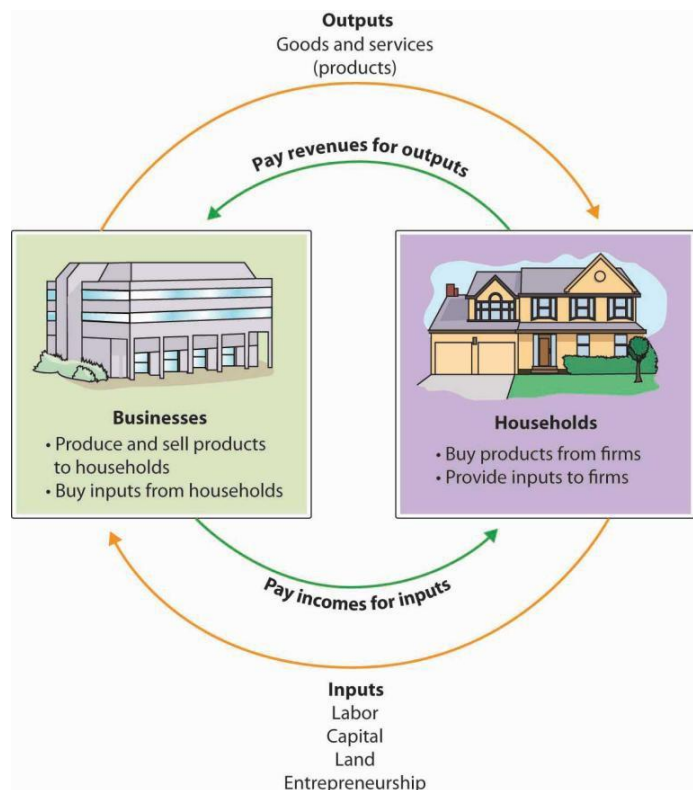


Figure 2 The Circular Flow of Inputs and Outputs

- Households not only provide factors of production (or resources) but also consume goods and services.
- Businesses not only buy resources but also produce and sell both goods and services.

The Questions Economists Ask

Economists study the interactions between households and businesses and look at the ways in which the factors of production are combined to produce the goods and services that people need. Basically, economists try to answer three sets of questions:

1. *What goods and services should be produced to meet consumers' needs? In what quantity? When should they be produced?*
2. *How should goods and services be produced? Who should produce them, and what resources, including technology, should be combined to produce them?*
3. *Who should receive the goods and services produced? How should they be allocated among consumers?*

Economic Systems

The answers to these questions depend on a country's economic system—the means by which a society (households, businesses, and government) makes decisions about allocating resources to produce products and about distributing those products. The degree to which individuals and business owners, as opposed to the government, enjoy freedom in making these decisions varies according to the type of economic system. Generally speaking, economic systems can be divided into two systems: *planned systems* and *free market systems*.

Planned Systems

In a planned system, the government exerts control over the allocation and distribution of all or some goods and services. The system with the highest level of government control is communism. In theory, a communist economy is one in which the government owns all or most enterprises. Central planning by the government dictates which goods or services are produced, how they are produced, and who will receive them. In practice, pure communism is practically nonexistent today, and only a few countries (notably North Korea and Cuba) operate under rigid, centrally planned economic systems. Under socialism, industries that provide essential services, such as utilities, banking, and health care, may be government owned. Other businesses are owned privately. Central planning allocates the goods and services produced by government-run industries and tries to

ensure that the resulting wealth is distributed equally. In contrast, privately owned companies are operated for the purpose of making a profit for their owners. In general, workers in socialist economies work fewer hours, have longer vacations, and receive more health care, education, and child-care benefits than do workers in capitalist economies. To offset the high cost of public services, taxes are generally steep. Examples of socialist countries include Sweden and France.

Free Market System

The economic system in which most businesses are owned and operated by individuals is the free market system, also known as capitalism. As we will see next, in a free market, *competition* dictates how goods and services will be allocated. Business is conducted with only limited government involvement. The economies of the United States and other countries, such as Japan, are based on capitalism.

How Economic Systems Compare

In comparing economic systems, it's helpful to think of a continuum with communism at one end and pure capitalism at the other, as in Figure 3 "The Spectrum of Economic Systems". As you move from left to right, the amount of government control over business diminishes. So, too, does the level of social services, such as health care, child-care services, social security, and unemployment benefits.

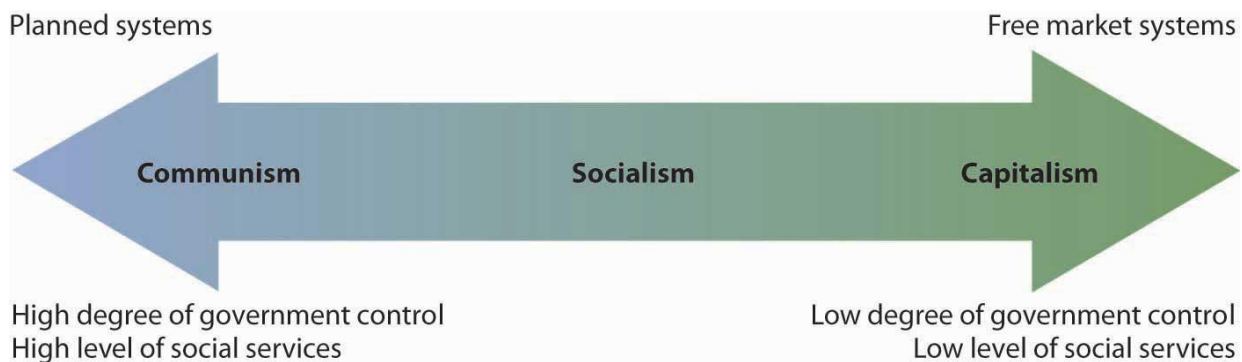


Figure 3 The Spectrum of Economic Systems

Mixed Market Economy

Though it's possible to have a pure communist system, or a pure capitalist (free market) system, in reality many economic systems are mixed. A mixed market economy relies on both markets and the government to allocate resources. We've already seen that this is

what happens in socialist economies in which the government controls selected major industries, such as transportation and health care, while allowing individual ownership of other industries. Even previously communist economies, such as those of Eastern Europe and China, are becoming more mixed as they adopt capitalistic characteristics and convert businesses previously owned by the government to private ownership through a process called privatization.

The U.S. Economic System

Like most countries, the United States features a mixed market system: though the U.S. economic system is primarily a free market system, the federal government controls some basic services, such as the postal service and air traffic control. The U.S. economy also has some characteristics of a socialist system, such as providing social security retirement benefits to retired workers.

The free market system was espoused by Adam Smith in his book *The Wealth of Nations*, published in 1776.² According to Smith, competition alone would ensure that consumers received the best products at the best prices. In the kind of competition he assumed, a seller who tries to charge more for his product than other sellers won't be able to find any buyers. A job-seeker who asks more than the going wage won't be hired. Because the "invisible hand" of competition will make the market work effectively, there won't be a need to regulate prices or wages.

Almost immediately, however, a tension developed among free market theorists between the principle of *laissez-faire*—leaving things alone—and government intervention. Today, it's common for the U.S. government to intervene in the operation of the economic system. For example, government exerts influence on the food and pharmaceutical industries through the Food and Drug Administration, which protects consumers by preventing unsafe or mislabeled products from reaching the market.

To appreciate how businesses operate, we must first get an idea of how prices are set in competitive markets. Thus, Section 1.4 "Perfect Competition and Supply and Demand" begins by describing how markets establish prices in an environment of perfect competition.

Key Takeaways

- **Economics** is the study of the production, distribution, and consumption of goods and services.
- Economists address these three questions: (1) What goods and services should be produced to meet consumer needs? (2) How should they be produced, and who should produce them? (3) Who should receive goods and services?
- The answers to these questions depend on a country's **economic system**. The primary economic systems that exist today are planned and free market systems.
- In a planned system, such as **communism** and **socialism**, the government exerts control over the production and distribution of all or some goods and services.
- In a **free market system**, also known as **capitalism**, business is conducted with only limited government involvement. Competition determines what goods and services are produced, how they are produced, and for whom.

Perfect Competition and Supply and Demand

Learning Objective

1. Describe perfect competition, and explain how supply and demand interact to set prices in a free market system.

Under a mixed economy, such as we have in the United States, businesses make decisions about which goods to produce or services to offer and how they are priced. Because there are many businesses making goods or providing services, customers can choose among a wide array of products. The competition for sales among businesses is a vital part of our economic system. Economists have identified four types of competition—*perfect competition*, *monopolistic competition*, *oligopoly*, and *monopoly*. We'll introduce the first of these—perfect competition—in this section and cover the remaining three in the following section.

Perfect Competition

Perfect competition exists when there are many consumers buying a standardized product from numerous small businesses. Because no seller is big enough or influential enough to affect price, sellers and buyers accept the going price. For example, when a commercial fisher brings his fish to the local market, he has little control over the price he gets and must accept the going market price.

The Basics of Supply and Demand

To appreciate how perfect competition works, we need to understand how buyers and sellers interact in a market to set prices. In a market characterized by perfect competition, price is determined through the mechanisms of *supply* and *demand*. Prices are influenced both by the supply of products from sellers and by the demand for products by buyers.

To illustrate this concept, let's create a *supply and demand schedule* for one particular good sold at one point in time. Then we'll define *demand* and create a *demand curve* and define *supply* and create a *supply curve*. Finally, we'll see how supply and demand interact to create an *equilibrium price*—the price at which buyers are willing to purchase the amount that sellers are willing to sell.

Demand and the Demand Curve

Demand is the quantity of a product that buyers are willing to purchase at various prices. The quantity of a product that people are willing to buy depends on its price. You're typically willing to buy *less* of a product when prices *rise* and *more* of a product when prices *fall*. Generally speaking, we find products more attractive at lower prices, and we buy more at lower prices because our income goes further.

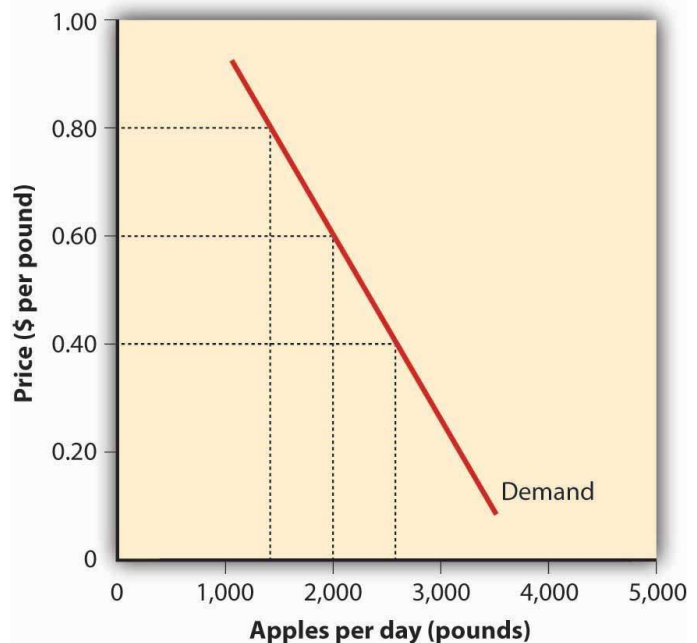


Figure 4 The Demand Curve

Using this logic, we can construct a demand curve that shows the quantity of

a product that will be demanded at different prices. Let's assume that the diagram in Figure 4 "The Demand Curve" represents the daily price and quantity of apples sold by farmers at a local market. Note that as the price of apples goes down, buyers' demand goes up. Thus, if a pound of apples sells for \$0.80, buyers will be willing to purchase only fifteen hundred pounds per day. But if apples cost only \$0.60 a pound, buyers will be willing to purchase two thousand pounds. At \$0.40 a pound, buyers will be willing to purchase twenty-five hundred pounds.

Supply and the Supply Curve

Supply is the quantity of a product that sellers are willing to sell at various prices. The quantity of a product that a business is willing to sell depends on its price. Businesses are

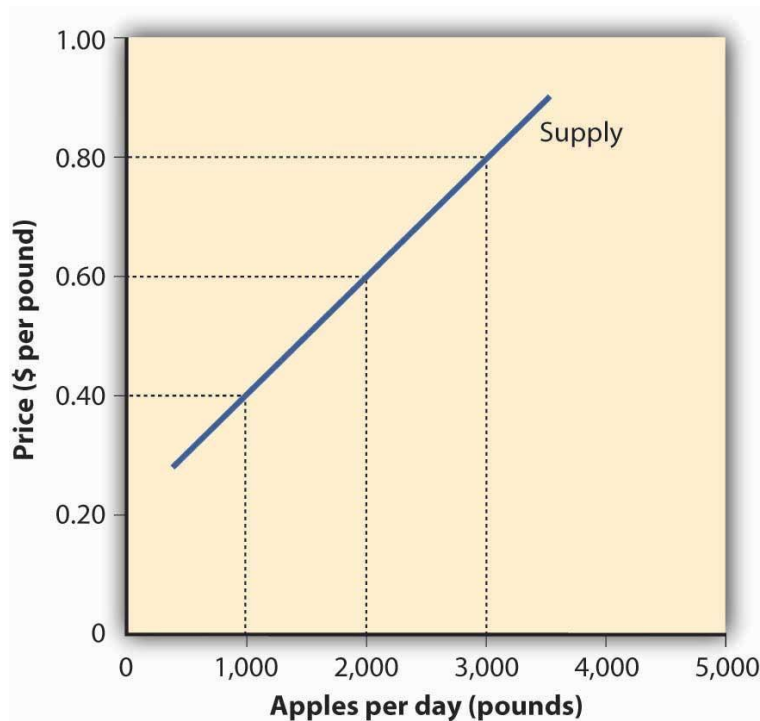


Figure 5 The Supply Curve

more willing to sell a product when the price rises and less willing to sell it when prices fall. Again, this fact makes sense: businesses are set up to make profits, and there are larger profits to be made when prices are high.

Now we can construct a supply curve that shows the quantity of apples that farmers would be willing to sell at different prices, regardless of demand. As you can see in Figure 5 "The Supply Curve", the supply curve goes in the

opposite direction from the demand curve: as prices rise, the quantity of apples that farmers are willing to sell also goes up. The supply curve shows that farmers are willing to sell only a thousand pounds of apples when the price is \$0.40 a pound, two thousand pounds when the price is \$0.60, and three thousand pounds when the price is \$0.80.

Equilibrium Price

We can now see how the market mechanism works under perfect competition. We do this

by plotting both the supply curve and the demand curve on one graph, as we've done in Figure 6 "The Equilibrium Price". The point at which the two curves intersect is the equilibrium price. At this point, buyers' demand for apples and sellers' supply of apples is in equilibrium.

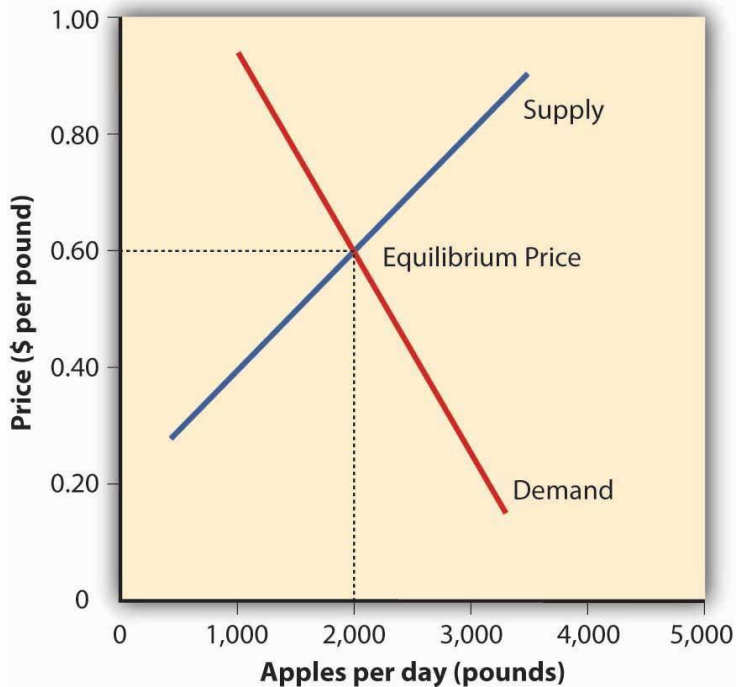


Figure 6 The Equilibrium Price

You can see in Figure 6 "The Equilibrium Price" that the supply and demand curves intersect at the price of \$0.60 and quantity of two thousand pounds. Thus, \$0.60 is the equilibrium price: at this price, the quantity of apples demanded by buyers equals the quantity of apples that farmers are willing to supply. If a farmer tries to charge more than \$0.60 for a pound of apples, he won't sell very many and his profits will go down. If, on the other hand, a farmer tries to charge less than the

equilibrium price of \$0.60 a pound, he will sell more apples but his profit per pound will be less than at the equilibrium price.

What have we learned in this discussion? We've learned that without outside influences, markets in an environment of perfect competition will arrive at an equilibrium point at which both buyers and sellers are satisfied. But we must be aware that this is a very simplistic example. Things are much more complex in the real world. For one thing, markets rarely operate without outside influences. Sometimes, sellers supply more of a product than buyers are willing to purchase; in that case, there's a *surplus*. Sometimes, they don't produce enough of a product to satisfy demand; then we have a *shortage*.

Circumstances also have a habit of changing. What would happen, for example, if income rose and buyers were willing to pay more for apples? The demand curve would change, resulting in an increase in equilibrium price. This outcome makes intuitive sense: as

demand increases, prices will go up. What would happen if apple crops were larger than expected because of favorable weather conditions? Farmers might be willing to sell apples at lower prices. If so, the supply curve would shift, resulting in another change in equilibrium price: the increase in supply would bring down prices.

Key Takeaways

- In a free market system, buyers and sellers interact in a market to set prices.
- When the market is characterized by **perfect competition**, many small companies sell identical products. Because no company is large enough to control price, each simply accepts the market price. The price is determined by supply and demand.
- **Supply** is the quantity of a product that sellers are willing to sell at various prices.
- **Demand** is the quantity of a product that buyers are willing to purchase at various prices.
- The quantity of a product that people will buy depends on its price: they'll buy more when the price is low and less when it's high.
- Price also influences the quantity of a product that producers are willing to supply: they'll sell more of a product when prices are high and less when they're low.
- In a competitive market, the decisions of buyers and sellers interact until the market reaches an **equilibrium price**—the price at which buyers are willing to buy the same amount that sellers are willing to sell.

Monopolistic Competition, Oligopoly, and Monopoly

Learning Outcomes

1. Describe monopolistic competition, oligopoly, and monopoly.

Economists have identified four types of competition—*perfect competition*, *monopolistic*

competition, oligopoly, and monopoly. Perfect competition was discussed in the last section; we'll cover the remaining three types of competition here.

Monopolistic Competition

In ***monopolistic competition***, we still have many sellers (as we had under perfect competition). Now, however, they don't sell identical products. Instead, they sell *differentiated* products—products that differ somewhat, or are *perceived* to differ, even though they serve a similar purpose. Products can be differentiated in a number of ways, including quality, style, convenience, location, and brand name. Some people prefer Coke over Pepsi, even though the two products are quite similar. But what if there was a substantial price difference between the two? In that case, buyers could be persuaded to switch from one to the other. Thus, if Coke has a big promotional sale at a supermarket chain, some Pepsi drinkers might switch (at least temporarily).

How is product differentiation accomplished? Sometimes, it's simply geographical; you probably buy gasoline at the station closest to your home regardless of the brand. At other times, perceived differences between products are promoted by advertising designed to convince consumers that one product is different from another—and better than it. Regardless of customer loyalty to a product, however, if its price goes too high, the seller will lose business to a competitor. Under monopolistic competition, therefore, companies have only limited control over price.

Oligopoly

Oligopoly means few sellers. In an oligopolistic market, each seller supplies a large portion of all the products sold in the marketplace. In addition, because the cost of starting a business in an oligopolistic industry is usually high, the number of firms entering it is low.

Companies in oligopolistic industries include such large-scale enterprises as automobile companies and airlines. As large firms supplying a sizable portion of a market, these companies have some control over the prices they charge. But there's a catch: because products are fairly similar, when one company lowers prices, others are often forced to follow suit to remain competitive. You see this practice all the time in the airline industry: When American Airlines announces a fare decrease, Continental, United Airlines, and others do likewise. When one automaker offers a special deal, its competitors usually

come up with similar promotions.

Monopoly

In terms of the number of sellers and degree of competition, monopolies lie at the opposite end of the spectrum from perfect competition. In perfect competition, there are many small companies, none of which can control prices; they simply accept the market price determined by supply and demand. In a **monopoly**, however, there's only one seller in the market. The market could be a geographical area, such as a city or a regional area, and doesn't necessarily have to be an entire country.

There are few monopolies in the United States because the government limits them. Most fall into one of two categories: *natural* and *legal*. **Natural monopolies** include public utilities, such as electricity and gas suppliers. Such enterprises require huge investments, and it would be inefficient to duplicate the products that they provide. They inhibit competition, but they're legal because they're important to society. In exchange for the right to conduct business without competition, they're regulated. For instance, they can't charge whatever prices they want, but they must adhere to government-controlled prices. As a rule, they're required to serve all customers, even if doing so isn't cost efficient.

A **legal monopoly** arises when a company receives a patent giving it exclusive use of an invented product or process. Patents are issued for a limited time, generally twenty years.³ During this period, other companies can't use the invented product or process without permission from the patent holder. Patents allow companies a certain period to recover the heavy costs of researching and developing products and technologies. A classic example of a company that enjoyed a patent-based legal monopoly is Polaroid, which for years held exclusive ownership of instant-film technology.⁴ Polaroid priced the product high enough to recoup, over time, the high cost of bringing it to market. Without competition, in other words, it enjoyed a monopolistic position in regard to pricing.

Key Takeaways

- There are four types of competition in a free market system: perfect competition, monopolistic competition, oligopoly, and monopoly.

- Under **monopolistic competition**, many sellers offer differentiated products—products that differ slightly but serve similar purposes. By making consumers aware of product differences, sellers exert some control over price.
- In an **oligopoly**, a few sellers supply a sizable portion of products in the market. They exert some control over price, but because their products are similar, when one company lowers prices, the others follow.
- In a **monopoly**, there is only one seller in the market. The market could be a geographical area, such as a city or a regional area, and does not necessarily have to be an entire country. The single seller is able to control prices.
- Most monopolies fall into one of two categories: natural and legal.
- **Natural monopolies** include public utilities, such as electricity and gas suppliers. They inhibit competition, but they're legal because they're important to society.
- A **legal monopoly** arises when a company receives a patent giving it exclusive use of an invented product or process for a limited time, generally twenty years.

Measuring the Health of the Economy

Learning Outcomes

1. Understand the criteria used to assess the status of the economy.

Every day, we are bombarded with economic news. We're told that the economy is struggling, unemployment is high, home prices are low, and consumer confidence is down. As a student learning about business, and later as a business manager, you need to understand the nature of the U.S. economy and the terminology that we use to describe it. You need to have some idea of where the economy is heading, and you need to know something about the government's role in influencing its direction.

Economic Goals

All the world's economies share three main goals:

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1. Growth
2. High employment
3. Price stability

Let's take a closer look at each of these goals, both to find out what they mean and to show how we determine whether they're being met.

Economic Growth

One purpose of an economy is to provide people with goods and services—cars, computers, video games, houses, rock concerts, fast food, amusement parks. One way in which economists measure the performance of an economy is by looking at a widely used measure of total output called gross domestic product (GDP). GDP is defined as the market value of all goods and services produced by the economy in a given year. In the United States, it's calculated by the Department of Commerce. GDP includes only those goods and services produced domestically; goods produced outside the country are excluded. GDP also includes only those goods and services that are produced for the final user; intermediate products are excluded. For example, the silicon chip that goes into a computer (an intermediate product) would not count, even though the finished computer would. By itself, GDP doesn't necessarily tell us much about the state of the economy. But *change* in GDP does. If GDP (after adjusting for inflation) goes up, the economy is growing. If it goes down, the economy is contracting.

The Business Cycle

The economic ups and downs resulting from expansion and contraction constitute the business cycle. A typical cycle runs from three to five years but could last much longer. Though typically irregular, a cycle can be divided into four general phases of *prosperity*, *recession*, *depression* (which the cycle generally skips), and *recovery*:

- During *prosperity*, the economy expands, unemployment is low, incomes rise, and consumers buy more products. Businesses respond by increasing production and offering new and better products.
- Eventually, however, things slow down. GDP decreases, unemployment rises, and because people have less money to spend, business revenues decline. This

slowdown in economic activity is called a recession. Economists often say that we're entering a recession when GDP goes down for two consecutive quarters.

- Generally, a recession is followed by a *recovery* in which the economy starts growing again.
- If, however, a recession lasts a long time (perhaps a decade or so), while unemployment remains very high and production is severely curtailed, the economy could sink into a depression. Though not impossible, it's unlikely that the United States will experience another severe depression like that of the 1930s. The federal government has a number of economic tools (some of which we'll discuss shortly) with which to fight any threat of a depression.

Full Employment

To keep the economy going strong, people must spend money on goods and services. A reduction in personal expenditures for things like food, clothing, appliances, automobiles, housing, and medical care could severely reduce GDP and weaken the economy.

Because most people earn their spending money by working, an important goal of all economies is making jobs available to everyone who wants one. In principle, full employment occurs when everyone who wants to work has a job. In practice, we say that we have "full employment" when about 95 percent of those wanting to work are employed.

The Unemployment Rate

The U.S. Department of Labor tracks unemployment and reports the unemployment rate: the percentage of the labor force that's unemployed and actively seeking work. The unemployment rate is an important measure of economic health. It goes up during recessionary periods because companies are reluctant to hire workers when demand for goods and services is low. Conversely, it goes down when the economy is expanding and there is high demand for products and workers to supply them.

Figure 7 "The U.S. Unemployment Rate, 1970–2010" traces the U.S. unemployment rate between 1970 and 2010. If you want to know the current unemployment rate, go to the CNNMoney Web site (CNNMoney.com) and click on "Economy" and then on "Job Growth."

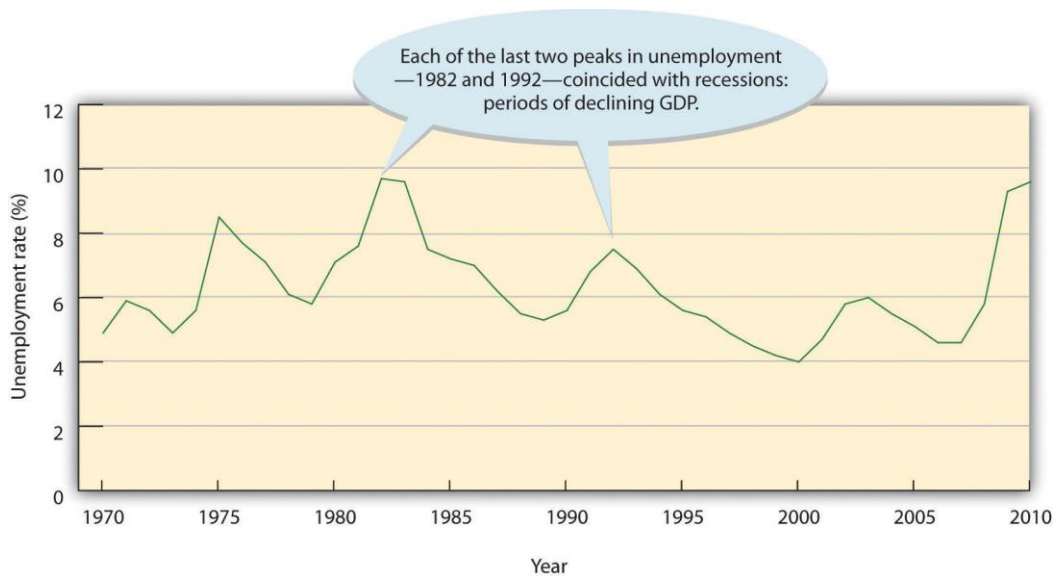


Figure 7 The U.S. Unemployment Rate, 1970–2010

Price Stability

A third major goal of all economies is maintaining price stability. Price stability occurs when the average of the prices for goods and services either doesn't change or changes very little. Rising prices are troublesome for both individuals and businesses. For individuals, rising prices mean you have to pay more for the things you need. For businesses, rising prices mean higher costs, and, at least in the short run, businesses might have trouble passing on higher costs to consumers. When the overall price level goes up, we have inflation. Figure 8 "The U.S. Inflation Rate, 1960–2010" shows inflationary trends in the U.S. economy since 1960. When the price level goes down (which rarely happens), we have deflation.

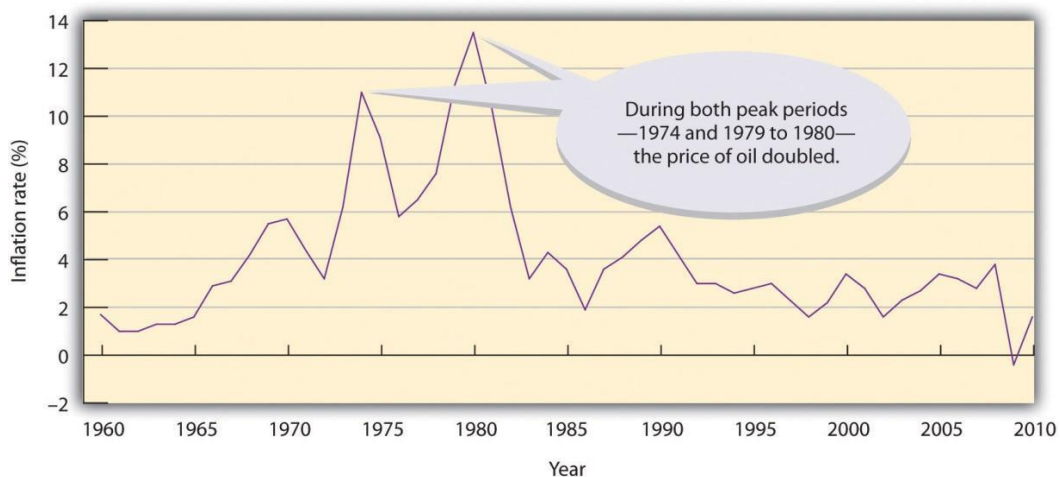


Figure 8 The U.S. Inflation Rate, 1960–2010

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The Consumer Price Index

The most widely publicized measure of inflation is the consumer price index (CPI), which is reported monthly by the Bureau of Labor Statistics. The CPI measures the rate of inflation by determining price changes of a hypothetical basket of goods, such as food, housing, clothing, medical care, appliances, automobiles, and so forth, bought by a typical household.

The CPI base period is 1982 to 1984, which has been given an average value of 100.

Table 1 "Selected CPI Values, 1950–2010" gives CPI values computed for selected years. The CPI value for 1950, for instance, is 24. This means that \$1 of typical purchases in 1982 through 1984 would have cost \$0.24 in 1950. Conversely, you would have needed \$2.18 to purchase the same \$1 worth of typical goods in 2010. The difference registers the effect of inflation. In fact, that's what an *inflation rate* is—the *percentage change in a price index*. You can find out the current CPI by going to the CNNMoney Web site (CNNMoney.com) and click on "Economy" and then on "Inflation (CPI)."

Table 1 Selected CPI Values, 1950–2010

Year	1950	1960	1970	1980	1990	2000	2001	2002
CPI	24.1	29.1	38.8	82.4	130.7	172.2	177.1	179.9
Year	2003	2004	2005	2006	2007	2008	2009	2010
CPI	184.0	188.9	195.3	201.6	207.3	215.3	214.15	218.1

Economic Forecasting

In the previous section, we introduced several measures that economists use to assess the performance of the economy at a given time. By looking at changes in GDP, for instance, we can see whether the economy is growing. The CPI allows us to gauge inflation. These measures help us understand where the economy stands today. But what if we want to get a sense of where it's headed in the future? To a certain extent, we can forecast future economic trends by analyzing several leading economic indicators.

Economic Indicators

An economic indicator is a statistic that provides valuable information about the economy.

There's no shortage of economic indicators, and trying to follow them all would be an overwhelming task. Thus, economists and businesspeople track only a select few, including those that we'll now discuss.

Lagging and Leading Indicators

Statistics that report the status of the economy a few months in the past are called lagging economic indicators. One such indicator is *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 in the future are called leading economic indicators. If such an indicator rises, the economy is likely to expand in the coming year. If it falls, the economy is likely to contract.

To predict where the economy is headed, we obviously must examine several leading indicators. It's also helpful to look at indicators from various sectors of the economy—labor, manufacturing, and housing. One useful indicator of the outlook for future jobs is the number of new *claims for unemployment insurance*. This measure tells us how many people recently lost their jobs. If it's rising, it signals trouble ahead because unemployed consumers can't buy as many goods and services as they could if they had paychecks.

To gauge the level of goods to be produced in the future (which will translate into future sales), economists look at a statistic called *average weekly manufacturing hours*. This measure tells us the average number of hours worked per week by production workers in manufacturing industries. If it's on the rise, the economy will probably improve. For assessing the strength of the housing market, *building permits* is often a good indicator. An increase in this statistic—which tells us how many new housing units are being built—indicates that the economy is improving. Why? Because increased building brings money into the economy not only through new home sales but also through sales of furniture and appliances to furnish them.

Finally, if you want a measure that combines all these economic indicators, as well as others, a private research firm called the Conference Board publishes a U.S. *leading index*. To get an idea of what leading economic indicators are telling us about the state of the economy today, go to the Conference Board site at <https://www.conference-board.org/> and click on “U.S. Indicators” and then “leading economic index.”

Consumer Confidence Index

The Conference Board also publishes a consumer confidence index based on results of a monthly survey of five thousand U.S. households. The survey gathers consumers' opinions on the health of the economy and their plans for future purchases. It's often a good indicator of consumers' future buying intent. For information on current consumer confidence, go to the Conference Board site at <http://www.conference-board.org> and click on "consumer confidence."

Key Takeaways

- All economies share three goals: growth, high employment, and price stability.
- *Growth.* An economy provides people with goods and services, and economists measure its performance by studying the **gross domestic product (GDP)**—the market value of all goods and services produced by the economy in a given year.
- If GDP goes up, the economy is growing; if it goes down, the economy is contracting.
- *High employment.* Because most people earn their money by working, a goal of all economies is making jobs available to everyone who wants one.
- The U.S. government reports an **unemployment rate**—the percentage of the labor force that's unemployed and actively seeking work.
- The unemployment rate goes up during recessionary periods and down when the economy is expanding.
- *Price stability.* When the average prices of products either don't change or change very little, **price stability** occurs.
- When overall prices go up, we have **inflation**; when they go down, we have deflation.
- The consumer price index (CPI) measures inflation by determining the change in prices of a hypothetical basket of goods bought by a typical household.

Chapter 1 Review Questions

Multiple Choice:

1. This area addresses such questions as how much money does the company need.
 - a. Management
 - b. Operations
 - c. Marketing
 - d. Accounting
 - e. Finance
2. This area involves the conversion of resources.
 - a. Management
 - b. Operations
 - c. Marketing
 - d. Accounting
 - e. Finance
3. This represents the quantity of a product that a business is willing to sell depends on its price?
 - a. Perfect Competition
 - b. Supply
 - c. Demand
 - d. Equilibrium Price
4. _____ measures the rate of inflation by determining price changes.
 - a. Unemployment Rate
 - b. Consumer Price Index
 - c. Consumer Confidence Index
 - d. Gross Domestic Product
5. _____ gathers consumers' opinions on the health of the economy.
 - a. Unemployment Rate
 - b. Consumer Price Index
 - c. Consumer Confidence Index
 - d. Gross Domestic Product

Short Answer:

1. What are the five Functional Areas of Business?
2. What is the difference between Supply and Demand? What is the Equilibrium Price?
3. What are the three main goals of the world's economy?

Chapter 2 Business Ethics and Social Responsibility

Misgoverning Corporations: An Overview

Learning Objectives

1. Define business ethics and explain what it means to act ethically in business.
2. Explain how you can recognize an ethical organization.

The WorldCom situation is not an isolated incident. The boom years of the 1990s were followed by revelations of massive corporate corruption, including criminal schemes at companies such as Enron, Adelphia, and Tyco. In fall 2001, executives at Enron, an energy supplier, admitted to accounting practices concocted to overstate the company's income over a period of four years. In the wake of the company's collapse, stock prices plummeted from \$90 to \$1 a share, inflicting massive financial losses on the investment community. Thousands of employees lost not only their jobs but their retirement funds, as well.⁵ Before the Enron story was off the front pages, officials at Adelphia, the nation's sixth-largest cable company, disclosed that founder and CEO John Rigas had treated the publicly owned firm as a personal piggy bank, siphoning off billions of dollars to support his family's extravagant lifestyle and bankrupting the company in the process.⁶ Likewise, CEO Dennis Koslowzki of conglomerate Tyco International was apparently confused about what was his and what belonged to the company. Besides treating himself to a \$30 million estate in Florida and a \$7 million Park Avenue apartment, Koslowzki indulged in a taste for expensive office accessories—such as a \$15,000 umbrella stand, a \$17,000 traveling toilette box, and a \$2,200 wastebasket—that eventually drained \$600 million from company coffers.⁷

As crooked as these CEOs were, Bernie Madoff, founder of Bernard L. Madoff Investment Securities and former chairman of the NASDAQ stock exchange, makes them seem like dime-store shoplifters.⁸ Madoff is alleged to have run a giant Ponzi scheme⁹ that cheated investors of up to \$65 billion. His wrongdoings won him a spot at the top of *Time Magazine's* Top 10 Crooked CEOs. According to the SEC charges, Madoff convinced

investors to give him large sums of money. In return, he gave them an impressive 8 percent to 12 percent return a year. But Madoff never really invested their money. Instead, he kept it for himself. He got funds to pay the first investors their return (or their money back if they asked for it) by bringing in new investors. Everything was going smoothly until the fall of 2008, when the stock market plummeted and many of his investors asked for their money back. As he no longer had their money, the game was over and he had to admit that the whole thing was just one big lie. Thousands of investors, including many of his wealthy friends, not-so-rich retirees who trusted him with their life savings, and charitable foundations, were financially ruined. All those harmed by Madoff either directly or indirectly were pleased when he was sentenced to jail for one-hundred and fifty years.

Are these cases merely aberrations? A *Time*/CNN poll conducted in the midst of all these revelations found that 72 percent of those surveyed don't think so. They believe that breach of investor and employee trust represents an ongoing, long-standing pattern of deceptive behavior by officials at a large number of companies.¹⁰ If they're right, then a lot of questions need to be answered. Why do such incidents happen (and with such apparent regularity)? Who are the usual suspects? How long until the next corporate bankruptcy record is set? What action can be taken—by individuals, organizations, and the government—to discourage such behavior?

The Idea of Business Ethics

It's in the best interest of a company to operate ethically. Trustworthy companies are better at attracting and keeping customers, talented employees, and capital. Those tainted by questionable ethics suffer from dwindling customer bases, employee turnover, and investor mistrust.

Let's begin this section by addressing one of the questions that we posed previously: What can individuals, organizations, and government agencies do to foster an environment of ethical and socially responsible behavior in business? First, of course, we need to define two terms: *business ethics* and *social responsibility*. They're often used interchangeably, but they don't mean the same thing.

What Is Ethics?

You probably already know what it means to be ethical: to know right from wrong and to

know when you're practicing one instead of the other. At the risk of oversimplifying, then, we can say that business ethics is the application of ethical behavior in a business context. Acting ethically in business means more than simply obeying applicable laws and regulations: It also means being honest, doing no harm to others, competing fairly, and declining to put your own interests above those of your company, its owners, and its workers. If you're in business you obviously need a strong sense of what's right and what's wrong (not always an easy task). You need the personal conviction to *do* what's right, even if it means doing something that's difficult or personally disadvantageous.

What Is Social Responsibility?

Corporate social responsibility deals with actions that affect a variety of parties in a company's environment. A socially responsible company shows concern for its stakeholders—anyone who, like owners, employees, customers, and the communities in which it does business, has a “stake” or interest in it. We'll discuss corporate responsibility later in the chapter. At this point, we'll focus on ethics.

How Can You Recognize an Ethical Organization?

One goal of anyone engaged in business should be to foster ethical behavior in the organizational environment. How do we know when an organization is behaving ethically? Most lists of ethical organizational activities include the following criteria:

- Treating employees, customers, investors, and the public fairly
- Making fairness a top priority
- Holding every member personally accountable for his or her action
- Communicating core values and principles to all members
- Demanding and rewarding integrity from all members in all situations¹¹

Whether you work for a business or for a nonprofit organization, you probably have a sense of whether your employer is ethical or unethical. Employees at companies that consistently make *Business Ethics* magazine's list of the “100 Best Corporate Citizens” regard the items on the previous list as business as usual in the workplace. Companies that routinely win good-citizenship awards include Procter & Gamble, Hewlett-Packard, Intel, Avon Products, Cisco Systems, and Merck.¹²

By contrast, employees with the following attitudes tend to suspect that their employers aren't as ethical as they should be:

- They consistently feel uneasy about the work they do.
- They object to the way they're treated.
- They're uncomfortable about the way coworkers are treated.
- They question the appropriateness of management directives and policies.¹³

In the early 1990s, many workers in Sears automotive service centers shared suspicions about certain policies, including the ways in which they were supposed to deal with customers. In particular, they felt uncomfortable with a new compensation plan that rewarded them for selling alignments, brake jobs, shock absorbers, and other parts and services. Those who met quotas got bonuses; those who didn't were often fired.

The results shouldn't be surprising: In their zeal to meet quotas and keep their jobs, some employees misled customers into believing they needed parts and services when, in fact, they were not needed. Before long, Sears was flooded with complaints from customers—as were law-enforcement officials—in more than forty states. Sears denied any intent to deceive customers but was forced not only to eliminate sales commissions but also to pay out \$60 million in refunds.

Why Study Ethics?

Ideally, prison terms, heavy fines, and civil suits should put a damper on corporate misconduct, but, unfortunately, many experts suspect that this assumption may be a bit optimistic. Whatever the condition of the ethical environment in the near future, one thing seems clear: The next generation entering business—which includes most of you—will find a world much different than the one that waited for the previous generation. Recent history tells us in no uncertain terms that today's business students, many of whom are tomorrow's business leaders, need a much sharper understanding of the difference between what is and isn't ethically acceptable. As a business student, one of your key tasks is learning how to recognize and deal with the ethical challenges that will confront you.

Moreover, knowing right from wrong will make you more marketable as a job candidate.

Asked what he looked for in a new hire, Warren Buffet, the world's most successful investor, replied: "I look for three things. The first is personal integrity, the second is intelligence, and the third is a high energy level." He paused and then added: "But if you don't have the first, the second two don't matter."¹⁴

Key Takeaways

- It's in a company's best interest to act ethically. Trustworthy companies are better able to attract and keep customers, talented employees, and capital.
- **Business ethics** is the application of ethical behavior in a business context.
- Acting ethically in business means more than just obeying laws and regulations. It also means being honest, doing no harm to others, competing fairly, and declining to put your own interests above those of your employer and coworkers.
- To act ethically in business situations, you need a good idea of what's right and wrong (not always an easy task).
- You also need the personal conviction to do what's right even if it means doing something that's difficult or personally disadvantageous.
- Ethical organizations treat employees, customers, investors, and the public fairly. They make fairness a top priority, communicate core values to those in the organization, and demand and reward integrity from all members while holding them accountable for their actions

The Individual Approach to Ethics

Learning Objective

1. Specify the steps that you would take to solve an ethical dilemma and make an ethical decision.

Betty Vinson didn't start out at WorldCom with the intention of going to jail. She undoubtedly knew what the right behavior was, but the bottom line is that she didn't *do* it. How can you make sure that you do the right thing in the business world? How should you respond to the kinds of challenges that you'll be facing? Because your actions in the

business world will be strongly influenced by your moral character, let's begin by assessing your current moral condition. Which of the following best applies to you (select one)?

1. I'm always ethical.
2. I'm mostly ethical.
3. I'm somewhat ethical.
4. I'm seldom ethical.
5. I'm never ethical.

Now that you've placed yourself in one of these categories, here are some general observations. Few people put themselves below the second category. Most of us are ethical most of the time, and most people assign themselves to category number two—"I'm *mostly* ethical." Why don't more people claim that they're *always* ethical?

Apparently, most people realize that being ethical all the time takes a great deal of moral energy. If you placed yourself in category number two, ask yourself this question: How can I change my behavior so that I can move up a notch? The answer to this question may be simple. Just ask yourself an easier question: How would I like to be treated in a given situation?¹⁵

Unfortunately, practicing this philosophy might be easier in your personal life than in the business world. Ethical challenges arise in business because business organizations, especially large ones, have multiple stakeholders and because stakeholders make conflicting demands. Making decisions that affect multiple stakeholders isn't easy even for seasoned managers; and for new entrants to the business world, the task can be extremely daunting. Many managers need years of experience in an organization before they feel comfortable making decisions that affect various stakeholders. You can, however, get a head start in learning how to make ethical decisions by looking at two types of challenges that you'll encounter in the business world: *ethical dilemmas* and *ethical decisions*.

Addressing Ethical Dilemmas

An ethical dilemma is a morally problematic situation: You have to pick between two or more acceptable but often opposing alternatives that are important to different groups.

Experts often frame this type of situation as a “right-versus-right” decision. It’s the sort of decision that Johnson & Johnson (known as J&J) CEO James Burke had to make in 1982.¹⁶ On September 30, twelve-year-old Mary Kellerman of Chicago died after her parents gave her Extra-Strength Tylenol. That same morning, twenty-seven-year-old Adam Janus, also of Chicago, died after taking Tylenol for minor chest pain. That night, when family members came to console his parents, Adam’s brother and his wife took Tylenol from the same bottle and died within forty-eight hours. Over the next two weeks, four more people in Chicago died after taking Tylenol. The actual connection between Tylenol and the series of deaths wasn’t made until an off-duty fireman realized from news reports that every victim had taken Tylenol. As consumers panicked, J&J pulled Tylenol off Chicago-area retail shelves. Researchers discovered Tylenol capsules containing large amounts of deadly cyanide. Because the poisoned bottles came from batches originating at different J&J plants, investigators determined that the tampering had occurred after the product had been shipped.

So J&J wasn’t at fault. But CEO Burke was still faced with an extremely serious dilemma: Was it possible to respond to the tampering cases without destroying the reputation of a highly profitable brand?

Burke had two options:

1. He could recall only the lots of Extra-Strength Tylenol that were found to be tainted with cyanide. This was the path followed by Perrier executives in 1991 when they discovered that cases of bottled water had been poisoned with benzene. This option favored J&J financially but possibly put more people at risk.
2. Burke could order a nationwide recall—of all bottles of Extra-Strength Tylenol. This option would reverse the priority of the stakeholders, putting the safety of the public above stakeholders’ financial interests.

Burke opted to recall all 31 million bottles of Extra-Strength Tylenol on the market. The cost to J&J was \$100 million, but public reaction was quite positive. Less than six weeks after the crisis began, Tylenol capsules were reintroduced in new tamper-resistant bottles, and by responding quickly and appropriately, J&J was eventually able to restore the

Tylenol brand to its previous market position. When Burke was applauded for moral courage, he replied that he'd simply adhered to the long-standing J&J credo that put the interests of customers above those of other stakeholders. His only regret was that the tamperer was never caught.¹⁷



Figure 9 How to Face an Ethical Dilemma

If you're

wondering what your thought process should be if you're confronted with an ethical dilemma, you could do worse than remember the mental steps listed in Figure 1 "How to Face an Ethical Dilemma"—which happen to be the steps that James Burke took in addressing the Tylenol crisis:

1. **Define the problem:** How to respond to the tampering case without destroying the reputation of the Tylenol brand.
2. **Identify feasible options:** (1) Recall only the lots of Tylenol that were found to be tainted with cyanide or (2) order a nationwide recall of all bottles of Extra-Strength Tylenol.

3. **Assess the effect of each option on stakeholders:** Option 1 (recalling only the tainted lots of Tylenol) is cheaper but puts more people at risk. Option 2 (recalling all bottles of Extra-Strength Tylenol) puts the safety of the public above stakeholders' financial interests.
4. **Establish criteria for determining the most appropriate action:** Adhere to the J&J credo, which puts the interests of customers above those of other stakeholders.
5. **Select the best option based on the established criteria:** In 1982, Option 2 was selected, and a nationwide recall of all bottles of Extra-Strength Tylenol was conducted.

Making Ethical Decisions

In contrast to the “right-versus-right” problem posed by an ethical dilemma, an ethical decision entails a “right-versus-wrong” decision—one in which there is a right (ethical) choice and a wrong (unethical or illegal) choice. When you make a decision that’s unmistakably unethical or illegal, you’ve

Ask yourself:



Figure 10 How to Avoid an Ethical Lapse

committed an ethical lapse. Betty Vinson, for example, had an ethical lapse when she caved in to her bosses' pressure to cook the WorldCom books. If you're presented with what appears to be this type of choice, asking yourself the questions in Figure 2 "How to Avoid an Ethical Lapse" will increase your odds of making an ethical decision.

To test the validity of this approach, let's take a point-by-point look at Betty Vinson's decisions:

1. Her actions were clearly illegal.
2. They were unfair to the workers who lost their jobs and to the investors who suffered financial losses (and also to her family, who shared her public embarrassment).
3. She definitely felt bad about what she'd done.
4. She was embarrassed to tell other people what she had done.
5. Reports of her actions appeared in her local newspaper (and just about every other newspaper in the country).

So Vinson could have answered our five test questions with five yeses. To simplify matters, remember the following rule: If you answer yes to *any one of these five questions*, odds are that you're about to do something you shouldn't.

Revisiting Johnson & Johnson

As discussed earlier in this section, Johnson & Johnson received tremendous praise for the actions taken by its CEO, James Burke, in response to the 1982 Tylenol catastrophe. But things change. To learn how a company can destroy its good reputation, let's fast forward to 2008 and revisit J&J and its credo, which states, "We believe our first responsibility is to the doctors, nurses and patients, to mothers and fathers and all others who use our products and services. In meeting their needs everything we do must be of high quality."¹⁸ How could a company whose employees believed so strongly in its credo find itself under criminal and congressional investigation for a series of recalls due to defective products?¹⁹ In a three-year period, the company recalled twenty-four products, including Children's, Infants' and Adults' Tylenol, Motrin, and Benadryl;²⁰ 1-Day Acuvue

TruEye contact lenses sold outside the U.S.;²¹ and hip replacements.²²

Unlike the 1982 J&J Tylenol recall, no one died from the defective products, but customers were certainly upset to find they had purchased over-the-counter medicines for themselves and their children that were potentially contaminated with dark particles or tiny specks of metal;²³ contact lenses that contained a type of acid that caused stinging or pain when inserted in the eye;²⁴ and defective hip implants that required patients to undergo a second hip replacement.²⁵

Who bears the responsibility for these image-damaging blunders? We'll identify two individuals who were at least partially responsible for the decline of J&J's reputation: The first is the current CEO—William Weldon—who has been criticized for being largely invisible and publicly absent during the recalls.²⁶ Additionally, he admitted that he did not understand the consumer division where many of the quality control problems originated.²⁷ Some members of the board of directors were not pleased with his actions (or inactions) and were upset at the revenue declines from the high-profile recalls. Consequently, Weldon was given only a 3 percent raise for 2011, and his end-of-year bonus was cut by 45 percent. But don't cry for him: His annual compensation for the year (including salary, bonus, and stock options) was \$23 million—down from \$26 million in the previous year.²⁸

The second individual who was at least partially responsible for the decline of J&J's reputation is Colleen Goggins, Worldwide Chairman of J&J's Consumer Group, who was in charge of the factories that produced many of the recalled products. She was heavily criticized by fellow employees for her excessive cost-cutting measures and her propensity to replace experienced scientists with new hires.²⁹ In addition, she was implicated in an unbelievably foolish and extremely unethical behavior to avoid publically disclosing another J&J recall of a defective product.

Here is the story behind the unethical scheme: After learning that J&J had released packets of Motrin that did not dissolve correctly, the company hired contractors to go into convenience stores and secretly buy up every pack of Motrin on the shelves. The instructions given to the contractors were the following: "You should simply 'act' like a regular customer while making these purchases. THERE MUST BE NO MENTION OF THIS BEING A RECALL OF THE PRODUCT!"³⁰ In May 2010, when Goggins appeared

before a congressional committee investigating the “phantom recall,” she testified that she was not aware of the behavior of the contractors³¹ and that she had “no knowledge of instructions to contractors involved in the phantom recall to not tell store employees what they were doing.” In her September 2010 testimony to the House Committee on Oversight and Government Reform, she acknowledged that the company wrote those instructions. She also told the committee she was retiring. This had to be a major disappointment for her. Before J&J started falling apart, she was a contender to take over as CEO when Weldon retired. But, as is true with Weldon, don’t shed too many tears for her. Goggins departed from J&J a wealthy woman after cashing in one-third of her shares of company stock for \$3 million.³²

From a right-versus-wrong point of view, both Weldon and Goggins acted inappropriately. Their actions caused harm to others, including consumers, employees, and investors. They most likely felt badly about what happened, were embarrassed to discuss the situation with others, and regretted the fact that almost every newspaper in the country carried the story of J&J’s downfall.

Regardless of whom is to blame, the bottom line is this: What was once an admired company is tarnished. J&J went from a most admired company to a struggling company that will require more than a Band-Aid to heal its business wounds.³³ Whether J&J can regain the public’s trust is a question that no one can answer at this time. At this point, consumers have a right to ask the questions: Should I pay a premium for J&J products given the company’s recent track record of poor quality control?

What to Do When the Light Turns Yellow

Like our five questions, some ethical problems are fairly straightforward. Others, unfortunately, are more complicated, but it will help to think of our five-question test as a set of signals that will warn you that you’re facing a particularly tough decision—that you should think carefully about it and perhaps consult someone else. The situation is like approaching a traffic light. Red and green lights are easy; you know what they mean and exactly what to do. Yellow lights are trickier. Before you decide which pedal to hit, try posing our five questions. If you get a single yes, you’ll be much better off hitting the brake.³⁴

Key Takeaways

- Businesspeople face two types of ethical challenges: ethical dilemmas and ethical decisions.
- An **ethical dilemma** is a morally problematic situation in which you must choose between two or more alternatives that aren't equally acceptable to different groups.
- Such a dilemma is often characterized as a “right-versus-right” decision and is usually solved in a series of five steps:
 1. Define the problem and collect the relevant facts.
 2. Identify feasible options.
 3. Assess the effect of each option on **stakeholders** (owners, employees, customers, communities).
 4. Establish criteria for determining the most appropriate option.
 5. Select the best option, based on the established criteria.
- An **ethical decision** entails a “right-versus-wrong” decision—one in which there's a right (ethical) choice and a wrong (unethical or downright illegal) choice.
- When you make a decision that's unmistakably unethical or illegal, you've committed an **ethical lapse**.
- If you're presented with what appears to be an ethical decision, asking yourself the following questions will improve your odds of making an ethical choice:
 1. Is the action illegal?
 2. Is it unfair to some parties?
 3. If I take it, will I feel bad about it?
 4. Will I be ashamed to tell my family, friends, coworkers, or boss about my action?
 5. Would I want my decision written up in the local newspaper?
- If you answer yes to any one of these five questions, you're probably about to do something that you shouldn't.

Identifying Ethical Issues

Learning Outcome

1. Identify ethical issues that you might face in business, and analyze rationalizations for unethical behavior.

Make no mistake about it: When you enter the business world, you'll find yourself in situations in which you'll have to choose the appropriate behavior. How, for example, would you answer questions like the following?

- Is it OK to accept a pair of sports tickets from a supplier?
- Can I buy office supplies from my brother-in-law?
- Is it appropriate to donate company funds to my local community center?
- If I find out that a friend is about to be fired, can I warn her?
- Will I have to lie about the quality of the goods I'm selling?
- Can I take personal e-mails and phone calls at work?
- What do I do if I discover that a coworker is committing fraud?

Obviously, the types of situations are numerous and varied. Fortunately, we can break them down into a few basic categories: *bribes*, *conflicts of interest*, *conflicts of loyalty*, *issues of honesty and integrity*, and *whistle-blowing*. Let's look a little more closely at each of these categories.

Bribes versus Gifts

It's not uncommon in business to give and receive small gifts of appreciation. But when is a gift unacceptable? When is it really a bribe? If it's OK to give a bottle of wine to a corporate client during the holidays, is it OK to give a case of wine? If your company is trying to get a big contract, is it appropriate to send a gift to the key decision maker? If it's all right to invite a business acquaintance to dinner or to a ball game, is it also all right to offer the same person a fully paid weekend getaway?

There's often a fine line between a gift and a bribe. The questions that we've just asked, however, may help in drawing it, because they raise key issues in determining how a gesture should be interpreted: the cost of the item, the timing of the gift, the type of gift,

and the connection between the giver and the receiver. If you're on the receiving end, it's a good idea to refuse any item that's overly generous or given for the purpose of influencing a decision. But because accepting even small gifts may violate company rules, the best advice is to check on company policy.

JCPenney's "Statement of Business Ethics," for instance, states that employees can't accept any cash gifts or any noncash gifts except those that have a value below \$50 and that are generally used by the giver for promotional purposes. Employees can attend paid-for business functions, but other forms of entertainment, such as sports events and golf outings, can be accepted only if it's practical for the Penney's employee to reciprocate. Trips of several days can't be accepted under any circumstances.³⁵

Conflicts of Interest

Conflicts of interest occur when individuals must choose between taking actions that promote their personal interests over the interests of others or taking actions that don't. A conflict can exist, for example, when an employee's own interests interfere with, or have the potential to interfere with, the best interests of the company's stakeholders (management, customers, owners). Let's say that you work for a company with a contract to cater events at your college and that your uncle owns a local bakery.

Obviously, this situation could create a conflict of interest (or at least give the appearance of one—which, by the way, is a problem in itself). When you're called on to furnish desserts for a luncheon, you might be tempted to throw some business your uncle's way even if it's not in the best interest of the catering company that you work for. What should you do? You should probably disclose the connection to your boss, who can then arrange things so that your personal interests don't conflict with the company's. You may, for example, agree that if you're assigned to order products like those that your uncle makes, you're obligated to find another supplier. Or your boss may make sure that someone else orders bakery products.

The same principle holds that an employee shouldn't use private information about an employer for personal financial benefit. Say that you learn from a coworker at your pharmaceutical company that one of its most profitable drugs will be pulled off the market because of dangerous side effects. The recall will severely hurt the company's financial

performance and cause its stock price to plummet. Before the news becomes public, you sell all the stock you own in the company. What you've done isn't merely unethical: It's called insider trading, it's illegal, and you could go to jail for it.

Conflicts of Loyalty

Sometimes you find yourself in a bind between being loyal either to your employer or to a friend or family member. Perhaps you just learned that a coworker, a friend of yours, is about to be downsized out of his job. You also happen to know that he and his wife are getting ready to make a deposit on a house near the company headquarters. From a work standpoint, you know that you shouldn't divulge the information. From a friendship standpoint, though, you feel it's your duty to tell your friend. Wouldn't he tell you if the situation were reversed? So what do you do? As tempting as it is to be loyal to your friend, you shouldn't. As an employee, your primary responsibility is to your employer. You might be able to soften your dilemma by convincing a manager with the appropriate authority to tell your friend the bad news before he puts down his deposit.

Issues of Honesty and Integrity

Master investor Warren Buffet once told a group of business students the following: "I cannot tell you that honesty is the best policy. I can't tell you that if you behave with perfect honesty and integrity somebody somewhere won't behave the other way and make more money. But honesty is a good policy. You'll do fine, you'll sleep well at night and you'll feel good about the example you are setting for your coworkers and the other people who care about you."³⁶

If you work for a company that settles for its employees' merely obeying the law and following a few internal regulations, you might think about moving on. If you're being asked to deceive customers about the quality or value of your product, you're in an ethically unhealthy environment.

Think about this story:

"A chef put two frogs in a pot of warm soup water. The first frog smelled the onions, recognized the danger, and immediately jumped out. The second frog hesitated: The water felt good, and he decided to stay and relax for a minute. After all, he could always jump out when things got too hot (so to speak). As the water got hotter, however, the frog adapted

to it, hardly noticing the change. Before long, of course, he was the main ingredient in frog-leg soup.”³⁷



Figure 11 How to Maintain Honesty and Integrity

So, what's the moral of the story? Don't sit around in an ethically toxic environment and lose your integrity a little at a time; get out before the water gets too hot and your options have evaporated. Fortunately, a few rules can guide you. We've summed them up in Figure 3.

Whistle-Blowing

As we've seen, the misdeeds of Betty Vinson and her accomplices at WorldCom didn't go undetected. They caught the eye of Cynthia Cooper, the company's director of internal auditing. Cooper, of course, could have looked the other way, but instead she summoned up the

courage to be a whistle-blower—an individual who exposes illegal or unethical behavior in an organization. Like Vinson, Cooper had majored in accounting at Mississippi State and was a hard-working, dedicated employee. Unlike Vinson, however, she refused to be bullied by her boss, CFO Scott Sullivan. In fact, she had tried to tell not only Sullivan but also auditors from the huge Arthur Andersen accounting firm that there was a problem with WorldCom's books. The auditors dismissed her warnings, and when Sullivan angrily told her to drop the matter, she started cleaning out her office. But she didn't relent. She and her team worked late each night, conducting an extensive, secret investigation. Two months later, Cooper had evidence to take to Sullivan, who told her once again to back off. Again, however, she stood up to him, and though she regretted the consequences for her WorldCom coworkers, she reported the scheme to the company's board of directors. Within days, Sullivan was fired and the largest accounting fraud in history became public.

As a result of Cooper's actions, executives came clean about the company's financial situation. The conspiracy of fraud was brought to an end, and though public disclosure of WorldCom's problems resulted in massive stock-price declines and employee layoffs, investor and employee losses would have been greater without Cooper's intervention.

Even though Cooper did the right thing, the experience wasn't exactly gratifying. A lot of people applauded her action, but many coworkers shunned her; some even blamed her for the company's troubles. She's never been thanked by any senior executive at WorldCom. Five months after the fraud went public, new CEO Michael Capellas assembled what was left of the demoralized workforce to give them a pep talk on the company's future. The senior management team mounted the stage and led the audience in a rousing rendition of "If you're happy and you know it, clap your hands!" Cynthia Cooper wasn't invited.³⁸



Figure 12 Cynthia Cooper

Whistle-blowing often means career suicide. A survey of two hundred whistle-blowers conducted by the National Whistleblower Center found that half of them had been fired for blowing the whistle.³⁹ Even those who get to keep their jobs experience painful repercussions. As long as they stay, some people will treat them (as one whistle-blower puts it) "like skunks at a picnic"; if they leave, they're frequently blackballed in the industry.⁴⁰ On a positive note, there's the 2002 Sarbanes-Oxley Act, which protects whistle-blowers under federal law.

For her own part, Cynthia Cooper doesn't regret what she did. As she told a group of students at Mississippi State: "Strive to be persons of honor and integrity. Do not allow yourself to be pressured. Do what you know is right even if there may be a price to be paid."⁴¹ If your company tells employees to do whatever it takes, push the envelope, look the other way, and "be sure that we make our numbers," you have three choices: go along with the policy, try to change things, or leave. If your personal integrity is part of the equation, you're probably down to the last two choices.⁴²

Refusing to Rationalize

Despite all the good arguments in favor of doing the right thing, why do many reasonable people act unethically (at least at times)? Why do good people make bad choices?

According to one study, there are four common rationalizations for justifying misconduct:⁴³

1. *My behavior isn't really illegal or immoral.* Rationalizers try to convince themselves that an action is OK if it isn't downright illegal or blatantly immoral. They tend to operate in a gray area where there's no clear evidence that the action is wrong.
2. *My action is in everyone's best interests.* Some rationalizers tell themselves: "I know I lied to make the deal, but it'll bring in a lot of business and pay a lot of bills." They convince themselves that they're expected to act in a certain way, forgetting the classic parental parable about jumping off a cliff just because your friends are.⁴⁴
3. *No one will find out what I've done.* Here, the self-questioning comes down to "If I didn't get caught, did I really do it?" The answer is yes. There's a simple way to avoid succumbing to this rationalization: Always act as if you're being watched.
4. *The company will condone my action and protect me.* This justification rests on a fallacy. Betty Vinson may honestly have believed that her actions were for the good of the company and that her boss would, therefore, accept full responsibility (as he promised). When she goes to jail, however, she'll go on her own.

Here's another rule: If you find yourself having to rationalize a decision, it's probably a bad one. Over time, you'll develop and hone your ethical decision-making skills.

Key Takeaways

- When you enter the business world, you'll find yourself in situations in which you'll have to choose the appropriate behavior.
- You'll need to know how to distinguish a bribe from an acceptable gift.
- You'll encounter situations that give rise to a conflict of interest—situations in which you'll have to choose between taking action that promotes your personal interest and action that favors the interest of others.

- Sometimes you'll be required to choose between loyalty to your employer and loyalty to a friend or family member.
- In business, as in all aspects of your life, you should act with honesty and integrity.
- At some point in your career, you might become aware of wrongdoing on the part of others and will have to decide whether to report the incident and become a whistle-blower—an individual who exposes illegal or unethical behavior in an organization.
- Despite all the good arguments in favor of doing the right thing, some businesspeople still act unethically (at least at times). Sometimes they use one of the following rationalizations to justify their conduct:
 1. The behavior isn't really illegal or immoral.
 2. The action is in everyone's best interests.
 3. No one will find out what I've done.
 4. The company will condone my action and protect me.

Corporate Social Responsibility

Learning Objective

1. Define corporate social responsibility and explain how organizations are responsible to their stakeholders.

Corporate social responsibility refers to the approach that an organization takes in balancing its responsibilities toward different stakeholders when making legal, economic, ethical, and social decisions. What motivates companies to be “socially responsible” to their various stakeholders? We hope it's because they want to do the right thing, and for many companies, “doing the right thing” is a key motivator. The fact is, it's often hard to figure out what the “right thing” is: What's “right” for one group of stakeholders isn't necessarily just as “right” for another. One thing, however, is certain: Companies today are held to higher standards than ever before. Consumers and other groups consider not only the quality and price of a company's products but also its character. If too many groups see a company as a poor corporate citizen, it will have a harder time attracting qualified

employees, finding investors, and selling its products. Good corporate citizens, by contrast, are more successful in all these areas.

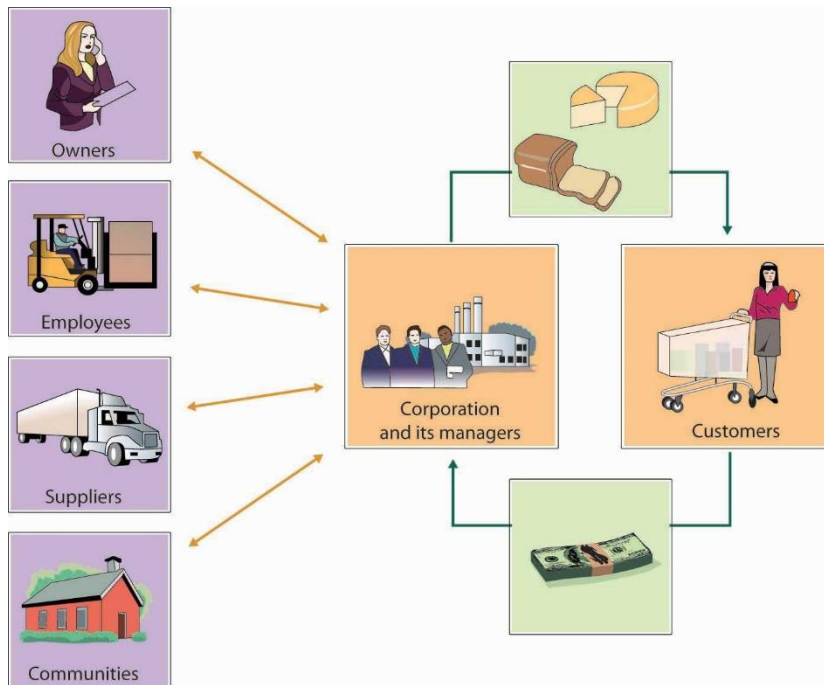


Figure 13 The Corporate Citizen

Figure 5, “The Corporate Citizen” presents a model of corporate responsibility based on a company’s relationships with its *stakeholders*. In this model, the focus is on managers—not owners—as the principals involved in all these relationships. Here, owners are the stakeholders who invest risk capital in the firm in expectation of a financial return. Other stakeholders include

employees, suppliers, and the communities in which the firm does business. Proponents of this model hold that customers, who provide the firm with revenue, have a special claim on managers’ attention. The arrows indicate the two-way nature of corporation-stakeholder relationships: All stakeholders have some claim on the firm’s resources and returns, and it is management’s job to make decisions that balance these claims.⁴⁵

Let’s look at some of the ways in which companies can be “socially responsible” in considering the claims of various stakeholders.

Owners

Owners invest money in companies. In return, the people who run a company have a responsibility to increase the value of owners’ investments through profitable operations. Managers also have a responsibility to provide owners (as well as other stakeholders having financial interests, such as creditors and suppliers) with accurate, reliable information about the performance of the business. Clearly, this is one of the areas in which WorldCom managers fell down on the job. Upper-level management purposely

deceived shareholders by presenting them with fraudulent financial statements.

Fiduciary Responsibilities

Finally, managers have a **fiduciary responsibility** to owners: They're responsible for safeguarding the company's assets and handling its funds in a trustworthy manner. This is a responsibility that was ignored by top executives at both Adelphia and Tyco, whose associates and families virtually looted company assets. To enforce managers' fiduciary responsibilities for a firm's financial statements and accounting records, the Sarbanes-Oxley Act of 2002 requires CEOs and CFOs to attest to their accuracy. The law also imposes penalties on corporate officers, auditors, board members, and any others who commit fraud.

Employees

Companies are responsible for providing employees with safe, healthy places to work— as well as environments that are free from sexual harassment and all types of discrimination. They should also offer appropriate wages and benefits. In the following sections, we'll take a closer look at each of these areas of responsibility.

Safety and Health

Though it seems obvious that companies should guard workers' safety and health, a lot of them simply don't. For over four decades, for example, executives at Johns Manville suppressed evidence

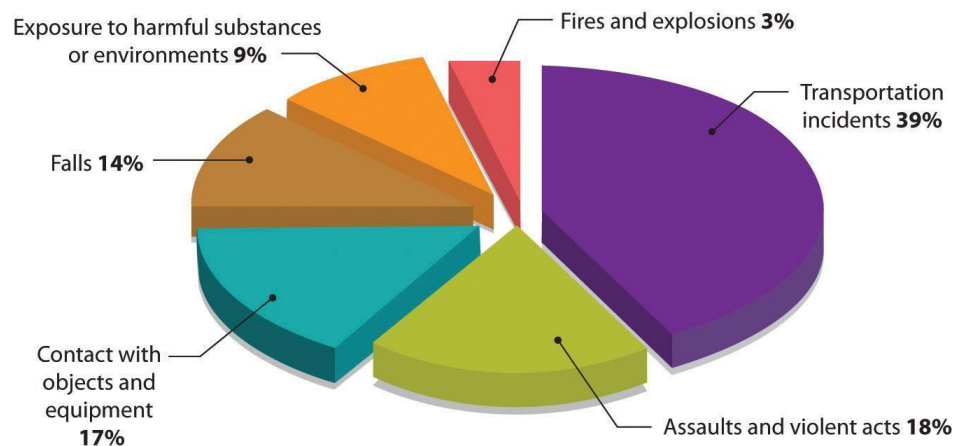


Figure 14 Workplace Deaths by Event or Exposure, 2010

that one of its products, asbestos, was responsible for the deadly lung disease developed by many of its workers.⁴⁶ The company concealed chest X-rays from stricken workers, and executives decided that it was simply cheaper to pay workers' compensation claims (or let workers die) than to create a safer work environment. A New Jersey court was quite blunt in its judgment: Johns Manville, it held, had made a deliberate, cold-blooded decision to do

nothing to protect at-risk workers, in blatant disregard of their rights.⁴⁷

About four in one hundred thousand U.S. workers die in workplace “incidents” each year. The Department of Labor categorizes deaths caused by conditions like those at Johns Manville as “exposure to harmful substances or environments.” How

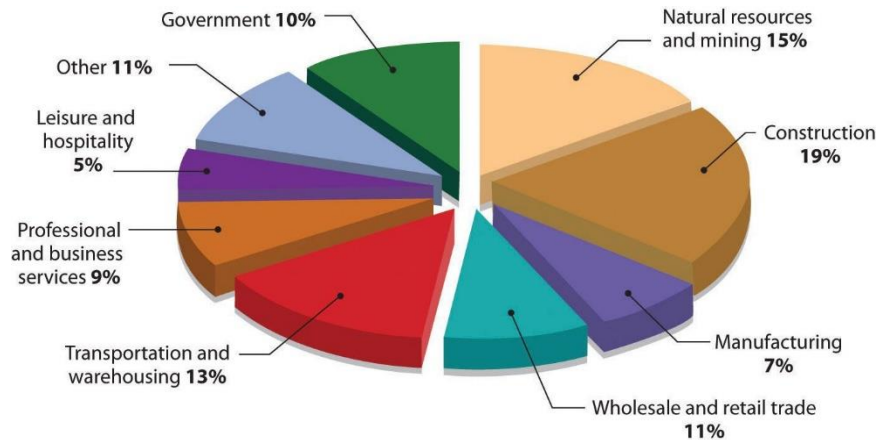


Figure 15 Workplace Deaths by Industry, 2010

prevalent is this condition as a cause of workplace deaths? See Figure 6, “Workplace Deaths by Event or Exposure, 2010”, which breaks down workplace fatalities by cause. Some jobs are more dangerous than others. For a comparative overview based on workplace deaths by occupation, see Figure 7, “Workplace Deaths by Industry, 2010”.

For most people, fortunately, things are better than they were at Johns Manville. Procter & Gamble (P&G), for example, considers the safety and health of its employees paramount



Figure 16 Requiring workers to wear protective clothing like gloves, hard hats, and goggles cuts down on accidents. It also helps the firm reduce time lost from work due to injuries.

and promotes the attitude that “Nothing we do is worth getting hurt for.” With nearly one hundred thousand employees worldwide, P&G uses a measure of worker safety called “total incident rate per employee,” which records injuries resulting in loss of consciousness, time lost from work, medical transfer to another job, motion restriction, or medical treatment beyond first aid.

The company attributes the low rate of such incidents—less than one incident per hundred employees—to a variety of programs to promote workplace safety.⁴⁸

Freedom from Sexual Harassment

What is *sexual harassment*? The law is quite precise:

Sexual harassment occurs when an employee makes “unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature” to another employee who doesn’t welcome the advances.

It’s also sexual harassment when “submission to or rejection of this conduct explicitly or implicitly affects an individual’s employment, unreasonably interferes with an individual’s work performance or creates an intimidating, hostile or offensive work environment.”⁴⁹

To prevent sexual harassment—or at least minimize its likelihood—a company should adopt a formal anti-harassment policy describing prohibited conduct, asserting its objections to the behavior, and detailing penalties for violating the policy.⁵⁰ Employers also have an obligation to investigate harassment complaints. Failure to enforce anti-harassment policies can be very costly. In 1998, for example, Mitsubishi paid \$34 million to more than three hundred fifty female employees of its Normal, Illinois, plant to settle a sexual harassment case supported by the Equal Employment Opportunity Commission. The EEOC reprimanded the company for permitting an atmosphere of verbal and physical abuse against women, charging that female workers had been subjected to various forms of harassment, ranging from exposure to obscene graffiti and vulgar jokes to fondling and groping.⁵¹

Equal Opportunity and Diversity

People must be hired, evaluated, promoted, and rewarded on the basis of merit, not personal characteristics. This, too, is the law—namely, Title VII of the 1964 Civil Rights Act. Like most companies, P&G has a formal policy on hiring and promotion that forbids discrimination based on race, color, religion, gender, age, national origin, citizenship, sexual orientation, or disability. P&G expects all employees to support its commitment to equal employment opportunity and warns that those who violate company policies will face strict disciplinary action, including termination of employment.⁵²

Equal Pay and the Wage Gap

The Equal Pay Act of 1963 requires equal pay for both men and women in jobs that entail equal skill, equal effort, equal responsibility, or similar working conditions. What has been

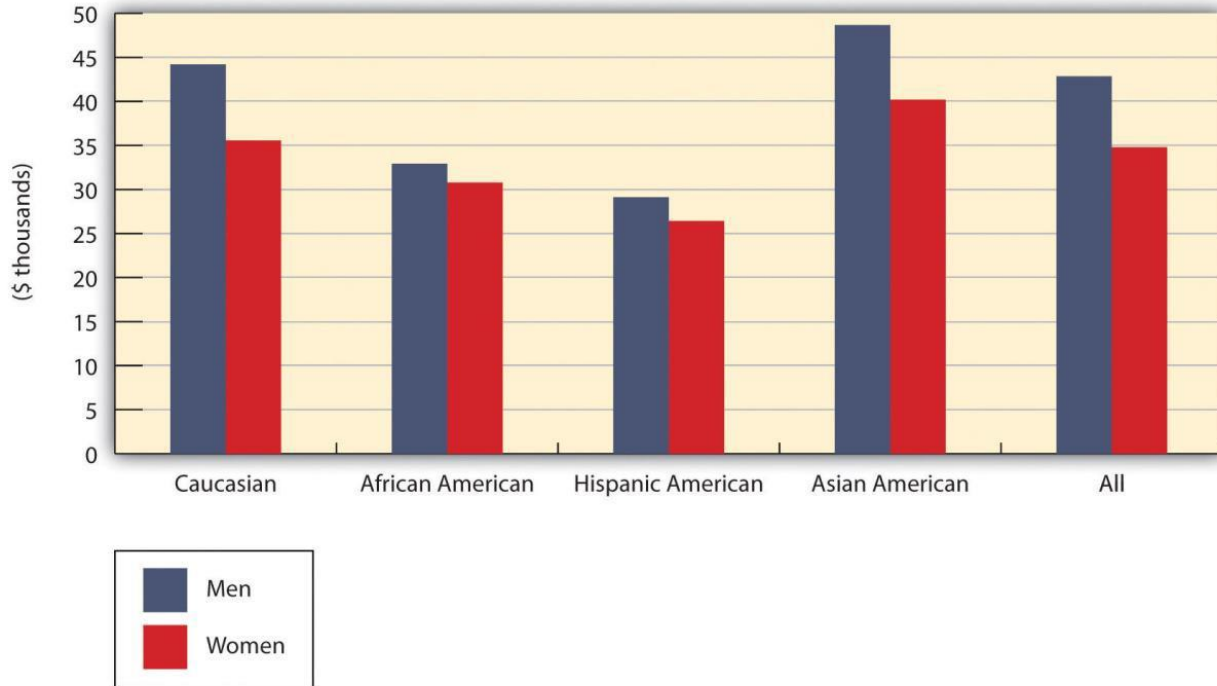


Figure 17 Median Annual Earnings by Gender and Race

the effect of the law after forty years? In 1963, women earned, on average, \$0.589 for every \$1 earned by men. By 2010, that difference—which we call the *wage gap*—has been closed to \$0.812 to \$1, or approximately 81 percent.⁵³ Figure 9 “Median Annual Earnings by Gender and Race” provides some interesting numbers on the differences in annual earnings based not only on gender but on race, as well. Figure 10, “Median Annual Earnings by Level of Education” throws further light on the wage and unemployment gap when education is taken into consideration.

What accounts for the difference, despite the mandate of federal law? For one thing, the jobs typically held by women tend to pay less than those typically held by men. In addition, men often have better job opportunities. For example, a man newly hired at the same time as a woman will often get a higher-paying assignment at the entry level. Coupled with the fact that the same sort of discrimination applies when it comes to training and promotions, women are usually relegated to a lifetime of lower earnings.

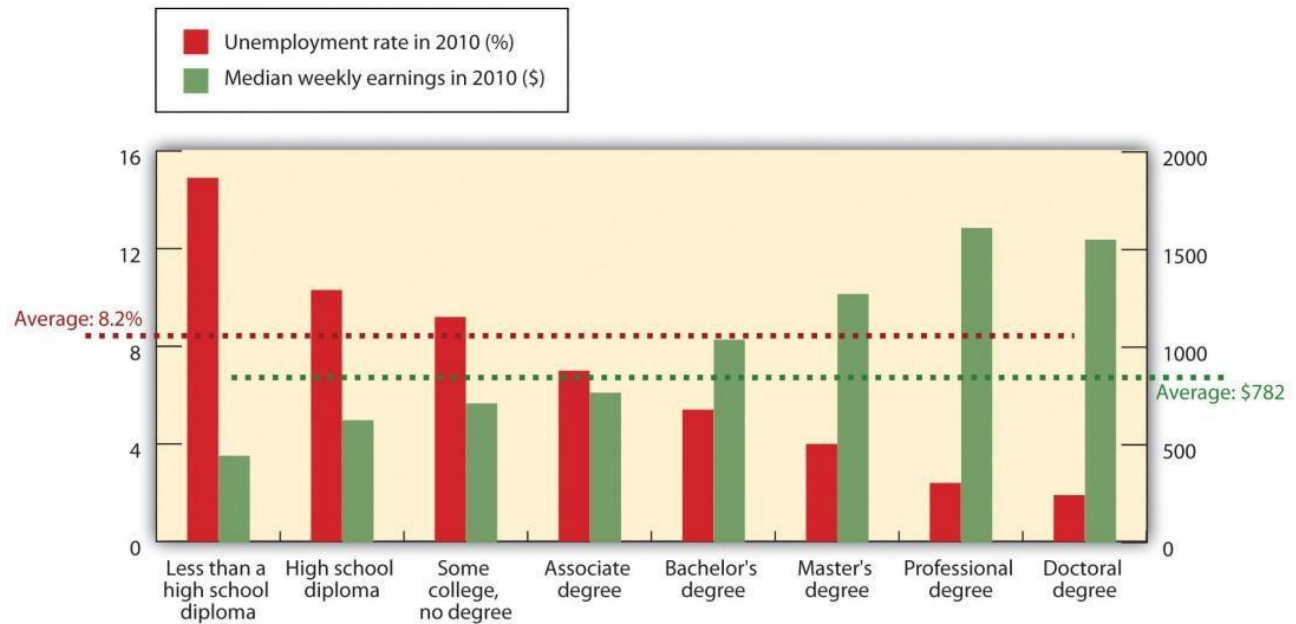


Figure 18 Median Annual Earnings by Level of Education. Education pays in higher earnings and lower unemployment rates. Note: Data are 2010 annual averages for persons age 25 and over. Earnings are for full-time wage and salary workers.

Building Diverse Workforces

In addition to complying with equal employment opportunity laws, many companies make special efforts to recruit employees who are underrepresented in the workforce according to sex, race, or some other characteristic. In helping to build more diverse workforces, such initiatives contribute to competitive advantage for two reasons: (1) People from diverse backgrounds bring new talents and fresh perspectives to an organization, typically enhancing creativity in the development of new products. (2) By reflecting more accurately the changing demographics of the marketplace, a diverse workforce improves a company's ability to serve an ethnically diverse population.

Wages and Benefits

At the very least, employers must obey laws governing minimum wage and overtime pay. A minimum wage is set by the federal government, though states can set their own rates. The current federal rate, for example, is \$7.25, while the rate in the state of Washington is \$11.00. When there's a difference, the higher rate applies.⁵⁴ By law, employers must also provide certain benefits—social security (which provides retirement benefits), unemployment insurance (which protects against loss of income in case of job loss), and workers' compensation (which covers lost wages and medical costs in case of on-the-job injury). Most large companies pay most of their workers more than minimum wage and offer considerably broader benefits, including medical, dental, and vision care, as well as

pension benefits.

Customers

The purpose of any business is to satisfy customers, who reward businesses by buying their products. Sellers are also responsible—both ethically and legally—for treating customers fairly. The rights of consumers were first articulated by President John F. Kennedy in 1962 when he submitted to Congress a presidential message devoted to consumer issues.⁵⁵ Kennedy identified four consumer rights:

1. ***The right to safe products.*** A company should sell no product that it suspects of being unsafe for buyers. Thus, producers have an obligation to safety-test products before releasing them for public consumption. The automobile industry, for example, conducts extensive safety testing before introducing new models (though recalls remain common).
2. ***The right to be informed about a product.*** Sellers should furnish consumers with the product information that they need to make an informed purchase decision. That's why pillows have labels identifying the materials used to make them, for instance.
3. ***The right to choose what to buy.*** Consumers have a right to decide which products to purchase, and sellers should let them know what their options are. Pharmacists, for example, should tell patients when a prescription can be filled with a cheaper brand-name or generic drug. Telephone companies should explain alternative calling plans.
4. ***The right to be heard.*** Companies must tell customers how to contact them with complaints or concerns. They should also listen and respond.

Companies share the responsibility for the legal and ethical treatment of consumers with several government agencies: the Federal Trade Commission (FTC), which enforces consumer-protection laws; the Food and Drug Administration (FDA), which oversees the labeling of food products; and the Consumer Product Safety Commission, which enforces laws protecting consumers from the risk of product-related injury.

Communities

For obvious reasons, most communities see getting a new business as an asset and view losing one—especially a large employer—as a detriment. After all, the economic impact of business activities on local communities is substantial: They provide jobs, pay taxes, and support local education, health, and recreation programs. Both big and small businesses donate funds to community projects, encourage employees to volunteer their time, and donate equipment and products for a variety of activities. Larger companies can make greater financial contributions. Let's start by taking a quick look at the philanthropic activities of a few U.S. corporations.

Financial Contributions

Many large corporations donate a percentage of sales or profits to worthwhile causes. Retailer Target, for example, donates 5 percent of its profits—about \$2 million per week—to schools, neighborhoods, and local projects across the country; its store-based grants underwrite programs in early childhood education, the arts, and family-violence prevention.⁵⁶ The late actor Paul Newman donated 100 percent of the profits from “Newman’s Own” foods (salad dressing, pasta sauce, popcorn, and other products sold in eight countries). His company continues his legacy of donating all profits and distributing them to thousands of organizations, including the Hole in the Wall Gang camps for seriously ill children.⁵⁷

Volunteerism

Many companies support employee efforts to help local communities. Patagonia, for example, a maker of outdoor gear and clothing, lets employees leave their jobs and work full-time for any environmental group for two months—with full salary and benefits; so far, more than 850 employees have taken advantage of the program.⁵⁸

Supporting Social Causes

Companies and executives often take active roles in initiatives to improve health and social welfare in the United States and elsewhere. Microsoft’s former CEO Bill Gates intends to distribute more than \$3 billion through the Bill and Melinda Gates Foundation, which funds global health initiatives, particularly vaccine research aimed at preventing infectious diseases, such as polio,⁵⁹ in undeveloped countries.⁶⁰ Noting that children from low-income families have twice as many cavities and often miss school because of dental-

related diseases, P&G invested \$1 million a year to set up “cavity-free zones” for 3.3 million economically disadvantaged children at Boys and Girls Clubs nationwide. In addition to giving away toothbrushes and toothpaste, P&G provided educational programs on dental hygiene. At some locations, the company even maintained clinics providing affordable oral care to poor children and their families.⁶¹ Proctor & Gamble recently committed to provide more than two billion liters of clean drinking water to adults and children living in poverty in developing countries. The company believes that this initiative will save an estimated ten thousand lives.⁶²

Key Takeaways

- **Corporate social responsibility** refers to the approach that an organization takes in balancing its responsibilities toward different stakeholders when making legal, economic, ethical, and social decisions.
- Companies are socially responsible to their various stakeholders—owners, employees, customers, and the communities in which they conduct business.
- Owners invest money in companies. In return, the people who manage companies have a responsibility to increase the value of owners’ investments through profitable operations.
- Managers have a responsibility to provide owners and other stakeholders with accurate, reliable financial information.
- They also have a **fiduciary responsibility** to safeguard the company’s assets and handle its funds in a trustworthy manner.
- Companies have a responsibility to guard workers’ safety and health and to provide them with a work environment that’s free from sexual harassment.
- Businesses should pay appropriate wages and benefits, treat all workers fairly, and provide equal opportunities for all employees.
- Many companies have discovered the benefits of valuing diversity. People with diverse backgrounds bring new talents and fresh perspectives, and improve a company’s ability to serve an ethnically diverse population.

- Sellers are responsible—both ethically and legally—for treating customers fairly. Consumers have certain rights: to use safe products, to be informed about products, to choose what to buy, and to be heard.
- Companies also have a responsibility to the communities in which they produce and sell their products. The economic impact of businesses on local communities is substantial. Companies have the following functions:
 1. Provide jobs
 2. Pay taxes
 3. Support local education, health, and recreation activities
 4. Donate funds to community projects
 5. Encourage employees to volunteer their time
 6. Donate equipment and products for a variety of activities

Stages of Corporate Responsibility

Learning Outcome

1. List the stages of corporate responsibility.

We expect companies to recognize issues of social importance and to address them responsibly. The companies that do this earn reputations as good corporate citizens and enjoy certain benefits, such as the ability to keep satisfied customers, to attract capital, and to recruit and retain talented employees. But companies don't become good corporate citizens overnight. Learning to identify and develop the capacity to address social concerns takes time and requires commitment. The task is arduous because so many different issues are important to so many different members of the public—issues ranging from the environment, to worker well-being (both at home and abroad), to fairness to customers, to respect for the community in which a company operates.

The Five Faces of Corporate Responsibility

Faced with public criticism of a particular practice, how does a company respond? What actions does it take to demonstrate a higher level of corporate responsibility? According to Harvard University's Simon Zadek, exercising greater corporate responsibility generally

means going through the series of five different stances summarized in *The Five Stages of Corporate Responsibility*.⁶³

1. *Defensive*. When companies are first criticized over some problem or issue, they tend to take a defensive, often legalistic stance. They reject allegations of wrongdoing and refuse to take responsibility, arguing that fixing the problem or addressing the issue isn't their job.
2. *Compliant*. During this stage, companies adopt policies that acknowledge the wishes of the public. As a rule, however, they do only what they have to do to satisfy their critics, and little more. They're acting mainly to protect brands or reputations and to reduce the risk of litigation.
3. *Managerial*. When it becomes clear that the problem won't go away, companies admit that they need to take responsibility and action, so they look for practical long-term solutions.
4. *Strategic*. At this point, they may start to reap the benefits of acting responsibly. They often find that responding to public needs gives them a competitive edge and enhances long-term success.
5. *Civil*. Ultimately, many companies recognize the importance of getting other companies to follow their lead. They may promote participation by other firms in their industries, endorsing the principle that the public is best served through collective action.

Here's Your Salad—How About Fries?

Several years ago, McDonald's found itself in a public relations nightmare. The fast-food giant faced massive public criticism for serving unhealthy food that contributed to a national epidemic of obesity. Let's look at McDonald's responses to these criticisms and assess how far along the five-stage process the company has progressed.

The Defensive Stage

As the documentary film *Super-Size Me* demonstrated, a steady diet of McDonald's burgers and fries will cause you to gain weight. It was certainly inevitable that one day the

public would make a connection between the rising level of obesity in the United States and a diet heavy in fat-laden fast foods. McDonald's fast food/obesity link got a lot of attention in 2002 when obese adults and teenagers filed suits against the company, claiming it was responsible for their excess pounds. McDonald's reaction to the public outcry against the company's menu items was defensive. For example, an owner of seven McDonald's in midtown Manhattan said, "We offer healthy choices. It is up to individuals to set limits and to be informed...McDonald's discloses nutritional information about its foods in its restaurants."⁶⁴

The Compliant Stage

In early 2004, the public's attention was drawn to McDonald's "super-size" options. Despite the fact that a super-sized meal delivered more than fifteen hundred calories, one in ten customers went for the upgrade. McDonald's faced daily criticisms on its super-sizing campaign, from nutritionists, doctors, advocacy groups, and lawyers who held it up as a "grossly overweight" poster child for U.S. obesity concerns. And the company feared public criticism would escalate when the movie *Super-Size Me* hit the theaters. The documentary tells the story of a young man who gained twenty-four pounds and wrecked his health by eating only McDonald's food for a month. Even worse, one scene shows him getting sick in his car after trying to wolf down a super-size meal. So McDonald's immediately moved from the defensive stage to the compliant stage and announced that it was eliminating its super-size option by the end of 2004. The move, though small, was in the right direction. It was touted by the company as a "menu simplification" process, but a spokesman did state, "It certainly is consistent with and on a parallel path with our ongoing commitment to a balanced lifestyle."⁶⁵

The Managerial Stage

Criticism of McDonald's continued as customers stayed away and its profits plummeted. The company searched for ways to win back customers and keep them long-term. To do this, it would have to come up with a healthier menu. Though McDonald's had served salads for years, they weren't very good. The company got serious about salads and introduced new, improved "premium salads," complete with Newman's Own salad dressing (a nice public relations touch, as all profits on the salad dressings are donated to charities). The company also improved the Happy Meal by letting kids substitute apple

slices and low-fat milk for the usual fries and soda. Oprah Winfrey's personal trainer was brought in to promote an adult version of the Happy Meal, called the GoActive meal, which includes a salad, a bottle of water, a book on nutrition, and a clip-on pedometer that measures the number of steps you take. The fat calories in Chicken McNuggets were lowered by coming out with all-white-meat McNuggets. And to appease those between-meal munchies, the company added a fruit-and-walnut salad to its menu. McDonald's goal was to convince customers that it had turned a corner and would forever more offer healthy choices to both adults and children.

The Strategic Stage

The new focus on healthy choices worked, and customers started returning. McDonald's salads were well received and accounted for about 10 percent of sales. Overall, things improved financially for the company: Sales increased and profits rose. To complete the transition to a healthier image, McDonald's came up with a new theme: helping adults and children live a balanced, active lifestyle. To go along with the theme, it launched a new active-life public-awareness campaign with the tagline "It's what I eat and what I do...I'm lovin' it." McDonald's demonstrated its concern for the health of its customers through permanent menu changes and an emphasis on the value of physical fitness. Even Ronald McDonald, the company's mascot, helped out by shooting hoops with NBA basketball star Yao Ming. The company launched a program called GoActive to help people find fun ways to build physical activity and fitness into their daily lives.

The Civil Stage

McDonald's hasn't advanced to the final stage yet; it hasn't enlisted the cooperation of other fast-food companies in encouraging children and adults to eat healthier foods. It's difficult to predict whether it will assume this role in the future, or even whether the company will stick with its healthier lifestyle theme. Indeed, it's hard to reconcile McDonald's commitment to helping people eat healthier with a promotion in the Chicago area that gave a free forty-two-ounce "super-size" soda to anyone buying a Big Mac and fries. Given that a Big Mac and medium fries deliver 910 calories, it's hard to justify encouraging customers to pile on an additional 410 calories for a big drink (at least, it's hard to justify this if you're promoting yourself as a company helping people eat better).⁶⁶

Key Takeaways

- Faced with public criticism of a particular practice, a company is likely to progress through five different stages:
 1. *Defensive*. When first criticized over some problem, companies take a defensive stance. They reject allegations of wrongdoing and refuse to take responsibility.
 2. *Compliant*. During this stage, companies do only what they have to do to satisfy their critics, protect brands or reputations, and reduce the risk of litigation.
 3. *Managerial*. When it's clear that the problem won't go away, companies take responsibility and look for long-term solutions.
 4. *Strategic*. At this point, they may start to reap the benefits of acting responsibly. Responding to public needs gives them a competitive edge and enhances long-term success.
 5. *Civil*. Ultimately, companies recognize the importance of getting other companies to follow their lead. They enlist the cooperation of other companies in supporting the issue of concern to the public.

Chapter 2 Review Questions

Multiple Choice:

- In the case of J&J, adherence to its credo is an example of _____.
 1. identify feasible options
 2. assess the effect of each option on stakeholders
 3. establish criteria for determining the most appropriate action
 4. select the best option on the established criteria
- Which is not a direct factor in the corporate citizen model?
 1. Owners
 2. Government
 3. Suppliers
 4. Customers
- Which is not a consumer right?
 1. The right to safe products
 2. The right to be informed about a product
 3. The right to buy what we want
 4. The right to be heard
- During this stage, companies adopt policies that acknowledge the wishes of the public.
 1. Defensive
 2. Compliant
 3. Managerial
 4. Civil
- At this point, businesses may start to reap the benefits of acting responsibly.
 1. Compliant
 2. Managerial
 3. Strategic
 4. Civil

Short Answer:

1. What is the difference between Business Ethics and Social Responsibility?
2. What are the five steps when facing an ethical dilemma?
3. What are the six functions that demonstrate a responsibility to the community?

Chapter 3 Business in a Global Environment

The Globalization of Business

Learning Outcomes

1. Explain why nations and companies participate in international trade.
2. Describe the concepts of absolute and comparative advantage.
3. Explain how trade between nations is measured.

The globalization of business is bound to affect you. Not only will you buy products manufactured overseas, but it's highly likely that you'll meet and work with individuals from various countries and cultures as customers, suppliers, colleagues, employees, or employers. The bottom line is that the globalization of world commerce has an impact on all of us. Therefore, it makes sense to learn more about how globalization works.

Never before has business spanned the globe the way it does today. But why is international business important? Why do companies and nations engage in international trade? What strategies do they employ in the global marketplace? What challenges do companies face when they do business overseas? How do governments and international agencies promote and regulate international trade? Is the globalization of business a good thing? What career opportunities are there for you in global business? How should you prepare yourself to take advantage of them? These are the questions that we'll be addressing in this chapter. Let's start by looking at the more specific reasons why companies and nations engage in international trade.

Why Do Nations Trade?

Why does the United States import automobiles, steel, digital phones, and apparel from other countries? Why don't we just make them ourselves? Why do other countries buy wheat, chemicals, machinery, and consulting services from us? Because no national economy produces all the goods and services that its people need. Countries are *importers* when they buy goods and services from other countries; when they sell products

to other nations, they're *exporters*. (We'll discuss importing and exporting in greater detail later in the chapter.) The monetary value of international trade is enormous. In 2010, the total value of worldwide trade in merchandise and commercial services was \$18.5 *trillion*.⁶⁷

Absolute and Comparative Advantage

To understand why certain countries import or export certain products, you need to realize that every country (or region) can't produce the same products. The cost of labor, the availability of natural resources, and the level of know-how vary greatly around the world. Most economists use the concepts of *absolute advantage* and *comparative advantage* to explain why countries import some products and export others.

Absolute Advantage

A nation has an absolute advantage if (1) it's the only source of a particular product or (2) it can make more of a product using the same amount of or fewer resources than other countries. Because of climate and soil conditions, for example, France had an absolute advantage in wine making until its dominance of worldwide wine production was challenged by the growing wine industries in Italy, Spain, and the United States. Unless an absolute advantage is based on some limited natural resource, it seldom lasts. That's why there are few, if any, examples of absolute advantage in the world today.

Comparative Advantage

How can we predict, for any given country, which products will be made and sold at home, which will be imported, and which will be exported? This question can be answered by looking at the concept of comparative advantage, which exists when a country can produce a product at a lower opportunity cost compared to another nation. But what's an *opportunity cost*? Opportunity costs are the products that a country must decline to make in order to produce something else. When a country decides to specialize in a particular product, it must sacrifice the production of another product.

Let's simplify things by imagining a world with only two countries—the Republic of High Tech and the Kingdom of Low Tech. We'll pretend that each country knows how to make two and only two products: wooden boats and telescopes. Each country spends half its resources (labor and capital) on each good. Figure 1 "Comparative Advantage in the Techs" shows the daily output for both countries: High Tech makes three boats and nine

telescopes while Low Tech makes two boats and one telescope. (They're not highly productive, as we've imagined two very small countries.)

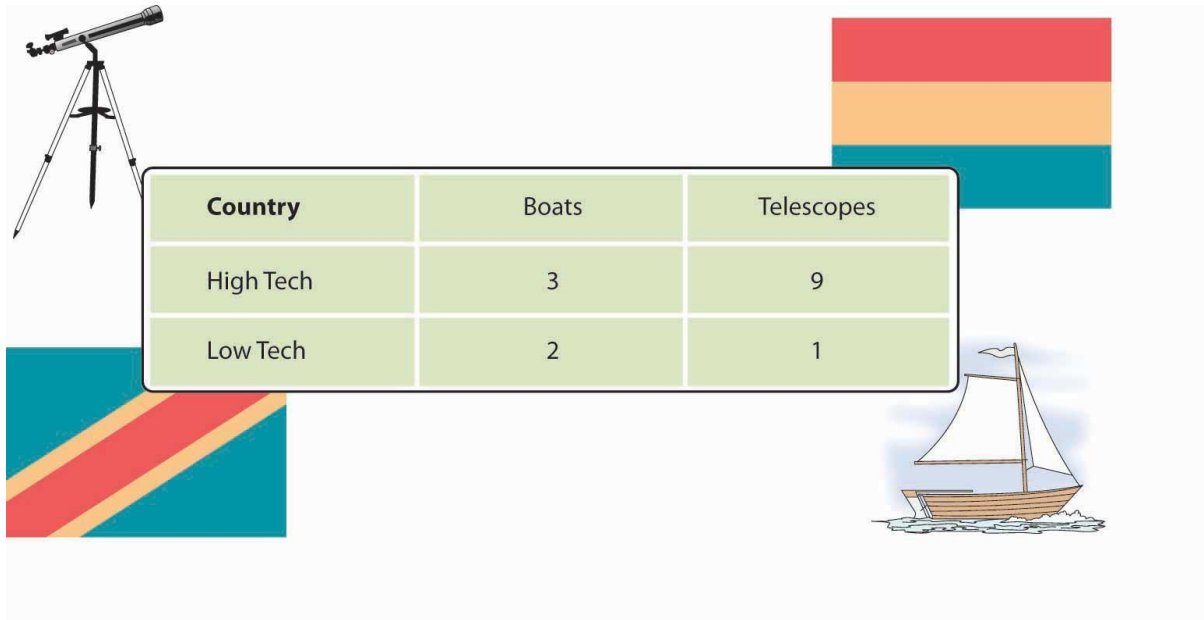


Figure 19 Comparative Advantage in the Techs

First, note that High Tech has an *absolute* advantage (relative to Low Tech) in both boats and telescopes: it can make more boats (three versus two) and more telescopes (nine versus one) than Low Tech can with the same resources. So, why doesn't High Tech make *all* the boats and *all* the telescopes needed for *both* countries? Because it lacks sufficient resources to make all the boats and all the telescopes, High Tech must, therefore, decide how much of its resources to devote to each of the two goods. Let's assume that each country could devote 100 percent of its resources on *either* of the two goods. We'll pick boats as a start. If both countries spend *all* their resources on boats (and make no telescopes), here's what happens:

1. When we assumed that High Tech spent half of its time on boats and half of its time on telescopes, it was able to make nine telescopes (see Figure 3.2 "Comparative Advantage in the Techs"). If it gives up the opportunity to make the nine telescopes, it can use the time gained by not making the telescopes to make three more boats (the number of boats it can make with half of its time). Because High Tech could make three more boats by giving up the opportunity to make the nine telescopes, the opportunity cost of making each boat is three telescopes ($9 \text{ telescopes} \div 3$

boats = 3 telescopes).

2. When we assumed that Low Tech spent half of its time on boats and half of its time on telescopes, it was able to make only one telescope (Figure 3.2 "Comparative Advantage in the Techs"). If it gives up the opportunity to make the telescope, it can use the time gained by not making the telescope to make two more boats. Because Low Tech could make two more boats by giving up the opportunity to make one telescope, the opportunity cost of making each boat is half a telescope ($1 \text{ telescope} \div 2 \text{ boats} = 1/2 \text{ of a telescope}$).
3. Low Tech, therefore, enjoys a *lower opportunity cost*. Because it must give up less to make the extra boats ($1/2 \text{ telescope vs. } 3 \text{ telescopes}$), it has a comparative advantage for boats. And because it's better—that is, more efficient—at making boats than at making telescopes, it should specialize in boat making.

Now to telescopes. Here's what happens if each country spends all its time making telescopes and makes no boats:

- When we assumed that High Tech spent half of its time on boats and half of its time on telescopes, it was able to make three boats (Figure 3.2 "Comparative Advantage in the Techs"). If it gives up the opportunity to make the three boats, it can use the time gained by not making the boats to make nine more telescopes. Because High Tech could make nine more telescopes by giving up the opportunity to make three boats, the opportunity cost of making each telescope is one-third of a boat ($3 \text{ boats} \div 9 \text{ telescopes} = 1/3 \text{ of a boat}$).
- When Low Tech spent half of its time on boats and half of its time on telescopes, it was able to make two boats. If it gives up the opportunity to make the two boats, it can use the time to make one more telescope. Thus, if High Tech wants to make only telescopes, it could make one more telescope by giving up the opportunity to make two boats. Thus, the opportunity cost of making each telescope is two boats ($2 \text{ boats} \div 1 \text{ telescope} = 2 \text{ boats}$).
- In this case, High Tech has the *lower opportunity cost*. Because it had to give up

less to make the extra telescopes (1/3 of a boat vs. 2 boats), it enjoys a comparative advantage for telescopes. And because it's better—more efficient—at making telescopes than at making boats, it should specialize in telescope making.

Each country will specialize in making the good for which it has a comparative advantage—that is, the good that it can make most efficiently, relative to the other country. High Tech will devote its resources to telescopes (which it's good at making), and Low Tech will put its resources into boat making (which it does well). High Tech will export its excess telescopes to Low Tech, which will pay for the telescopes with the money it earns by selling its excess boats to High Tech. Both countries will be better off. Things are a lot more complex in the real world, but, generally speaking, nations trade to exploit their advantages. They benefit from specialization, focusing on what they do best, and trading the output to other countries for what *they* do best. The United States, for instance, is increasingly an exporter of knowledge-based products, such as software, movies, music, and professional services (management consulting, financial services, and so forth). America's colleges and universities, therefore, are a source of comparative advantage, and students from all over the world come to the United States for the world's best higher-education system.

France and Italy are centers for fashion and luxury goods and are leading exporters of wine, perfume, and designer clothing. Japan's engineering expertise has given it an edge in such fields as automobiles and consumer electronics. And with large numbers of highly skilled graduates in technology, India has become the world's leader in low-cost, computer-software engineering.

How Do We Measure Trade between Nations?

To evaluate the nature and consequences of its international trade, a nation looks at two key indicators. We determine a country's balance of trade by subtracting the value of its imports from the value of its exports. If a country sells more products than it buys, it has a favorable balance, called a trade surplus. If it buys more than it sells, it has an unfavorable balance, or a trade deficit.

For many years, the United States has had a trade deficit: we buy far more goods from the rest of the world than we sell overseas. This fact shouldn't be surprising. With high income

levels, we not only consume a sizable portion of our own domestically produced goods but enthusiastically buy imported goods. Other countries, such as China and Taiwan, which manufacture primarily for export, have large trade surpluses because they sell far more goods overseas than they buy.

Managing the National Credit Card

Are trade deficits a bad thing? Not necessarily. They can be positive if a country's economy is strong enough both to keep growing and to generate the jobs and incomes that permit its citizens to buy the best the world has to offer. That was certainly the case in the United States in the 1990s. Some experts, however, are alarmed at our rapidly accelerating trade deficit. Investment guru Warren Buffet, for example, cautions that no country can continuously sustain large and burgeoning trade deficits. Why not? Because creditor nations will eventually stop taking IOUs from debtor nations, and when that happens, the national spending spree will have to cease. "Our national credit card," he warns, "allows us to charge truly breathtaking amounts. But that card's credit line is not limitless."⁶⁸

By the same token, trade surpluses aren't necessarily good for a nation's consumers. Japan's export-fueled economy produced high economic growth in the 1970s and 1980s. But most domestically made consumer goods were priced at artificially high levels inside Japan itself—so high, in fact, that many Japanese traveled overseas to buy the electronics and other high-quality goods on which Japanese trade was dependent. CD players and televisions were significantly cheaper in Honolulu or Los Angeles than in Tokyo. How did this situation come about? Though Japan manufactures a variety of goods, many of them are made for export. To secure shares in international markets, Japan prices its exported goods competitively. Inside Japan, because competition is limited, producers can put artificially high prices on Japanese-made goods. Due to a number of factors (high demand for a limited supply of imported goods, high shipping and distribution costs, and other costs incurred by importers in a nation that tends to protect its own industries), imported goods are also expensive.⁶⁹

Balance of Payments

The second key measure of the effectiveness of international trade is balance of payments:

the difference, over a period of time, between the total flow of money coming into a country and the total flow of money going out. As in its balance of trade, the biggest factor in a country's balance of payments is the money that comes in and goes out as a result of imports and exports. But balance of payments includes other cash inflows and outflows, such as cash received from or paid for foreign investment, loans, tourism, military expenditures, and foreign aid. For example, if a U.S. company buys some real estate in a foreign country, that investment counts in the U.S. balance of payments, but not in its balance of trade, which measures only import and export transactions. In the long run, having an unfavorable balance of payments can negatively affect the stability of a country's currency. Some observers are worried about the U.S. dollar, which has undergone an accelerating pattern of unfavorable balances of payments since the 1970s. For one thing, carrying negative balances has forced the United States to cover its debt by borrowing from other countries.⁷⁰ Figure 2 "U.S. Imports, Exports, and Balance of Payments, 1994–2010" provides a brief historical overview to illustrate the relationship between the United States' balance of trade and its balance of payments.

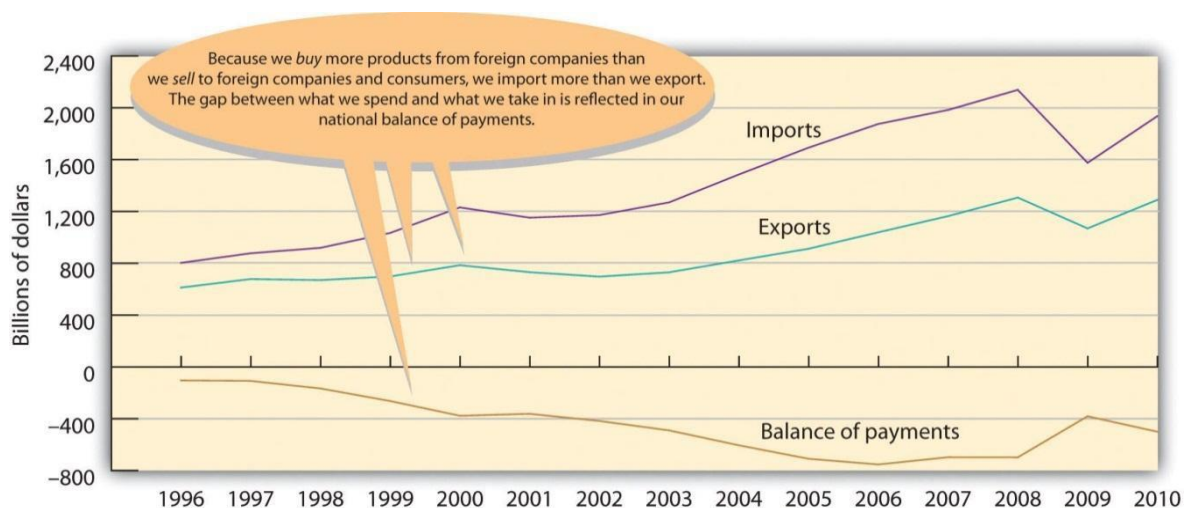


Figure 20 U.S. Imports, Exports, and Balance of Payments, 1994–2010. Note: Figures are for “goods” only, not “goods and services.” Source: U.S. Census Bureau, Foreign Trade Division.

Key Takeaways

- Nations trade because they don't produce all the products that their inhabitants need.

1. They import those that they need but don't produce and export those that are needed elsewhere.
 2. To understand why certain countries import or export certain products, you need to realize that not all countries are good at producing or are able to produce the same products.
 3. The cost of labor, the availability of natural resources, and the level of know-how vary greatly around the world.
- To explain how countries decide what products to import and export, economists use the concepts of *absolute* and *comparative advantage*.
 1. A nation has an **absolute advantage** if it's the only source of a particular product or can make more of a product with the same amount of or fewer resources than other countries.
 2. A **comparative advantage** exists when a country can produce a product at a lower *opportunity cost* than other nations.
 - Nations trade to exploit their advantages: they benefit from specialization, focusing on what they do best and trading the output to other countries for what *they* do best.
 - To evaluate the impact of its international trade, a nation looks at two key indicators: balance of trade and balance of payments.
 - We determine a country's **balance of trade** by subtracting the value of its imports from the value of its exports.
 1. If a country sells more products than it buys, it has a favorable balance, called a **trade surplus**.
 2. If it buys more than it sells, it has an unfavorable balance, or a **trade deficit**.
 - The **balance of payments** is the difference, over a period of time, between the total flow coming into a country and the total flow going out.
 1. As in its balance of trade, the biggest factor in a country's balance of payments is the money that comes in and goes out as a result of exports and imports.

2. But balance of payments includes other cash inflows and outflows, such as cash received from or paid for foreign investment, loans, tourism, military expenditures, and foreign aid.

Opportunities in International Business

Learning Outcomes

1. Define importing and exporting.
2. Explain how companies enter the international market through licensing agreements or franchises.
3. Describe how companies reduce costs through contract manufacturing and outsourcing.
4. Explain the purpose of international strategic alliances and joint ventures.
5. Understand how U.S. companies expand their businesses through foreign direct investments and international subsidiaries.
6. Understand the arguments for and against multinational corporations.

The fact that nations exchange billions of dollars in goods and services each year demonstrates that international trade makes good economic sense. For an American company wishing to expand beyond national borders, there are a variety of ways it can get involved in international business. Let's take a closer look at the more popular ones.

Importing and Exporting

Importing (buying products overseas and reselling them in one's own country) and exporting (selling domestic products to foreign customers) are the oldest and most prevalent forms of international trade. For many companies, importing is the primary link to the global market. American food and beverage wholesalers, for instance, import the bottled water Evian from its source in the French Alps for resale in U.S. supermarkets.⁷¹ Other companies get into the global arena by identifying an international market for their products and become exporters. The Chinese, for instance, are increasingly fond of fast foods cooked in soybean oil. Because they also have an increasing appetite for meat, they need high-protein soybeans to raise livestock.⁷² As a result, American farmers now export

over \$9 billion worth of soybeans to China every year.⁷³

Licensing and Franchising

A company that wants to get into an international market quickly while taking only limited financial and legal risks might consider licensing agreements with foreign companies. An international licensing agreement allows a foreign company (the *licensee*) to sell the products of a producer (the *licensor*) or to use its intellectual property (such as patents, trademarks, copyrights) in exchange for royalty fees. Here's how it works: You own a company in the United States that sells coffee-flavored popcorn. You're sure that your product would be a big hit in Japan, but you don't have the resources to set up a factory or sales office in that country. You can't make the popcorn here and ship it to Japan because it would get stale. So you enter into a licensing agreement with a Japanese company that allows your licensee to manufacture coffee-flavored popcorn using your special process and to sell it in Japan under your brand name. In exchange, the Japanese licensee would pay you a royalty fee.

Another popular way to expand overseas is to sell franchises. Under an international franchise agreement, a company (the *franchiser*) grants a foreign company (the *franchisee*) the right to use its brand name and to sell its products or services. The franchisee is responsible for all operations but agrees to operate according to a business model established by the franchiser. In turn, the franchiser usually provides advertising, training, and new-product assistance. Franchising is a natural form of global expansion for companies that operate domestically according to a franchise model, including restaurant chains, such as McDonald's and Kentucky Fried Chicken, and hotel chains, such as Holiday Inn and Best Western.

Contract Manufacturing and Outsourcing

Because of high domestic labor costs, many U.S. companies manufacture their products in countries where labor costs are lower.

This arrangement is called international contract manufacturing or outsourcing. A U.S. company might contract with a local company in a foreign country to manufacture one of its products. It will, however, retain control of product design and development and put its own label on the finished product. Contract manufacturing is quite common in the U.S.

apparel business, with most American brands being made in a number of Asian countries, including China, Vietnam, Indonesia, and India.⁷⁴

Thanks to twenty-first-century information technology, nonmanufacturing functions can also be outsourced to nations with lower labor costs. U.S. companies increasingly draw on a vast supply of relatively inexpensive skilled labor to perform various business services, such as software development, accounting, and claims processing. For years, American insurance companies have processed much of their claims-related paperwork in Ireland. With a large, well-educated population with English language skills, India has become a center for software development and customer-call centers for American companies. In the case of India, as you can see in Table 1 "Selected Hourly Wages, United States and India", the attraction is not only a large pool of knowledge workers but also significantly lower wages.⁷⁵

Table 2 Selected Hourly Wages, United States and India

Occupation	U.S. Wage per Hour (per year)	Indian Wage per Hour (per year)
Middle-level manager	\$29.40 per hour (\$60,000 per year)	\$6.30 per hour (\$13,000 per year)
Information technology specialist	\$35.10 per hour (\$72,000 per year)	\$7.50 per hour (\$15,000 per year)
Manual worker	\$13.00 per hour (\$27,000 per year)	\$2.20 per hour (\$5,000 per year)

Strategic Alliances and Joint Ventures

What if a company wants to do business in a foreign country but lacks the expertise or resources? Or what if the target nation's government doesn't allow foreign companies to operate within its borders unless it has a local partner? In these cases, a firm might enter into a strategic alliance with a local company or even with the government itself.

A strategic alliance is an agreement between two companies (or a company and a nation)

to pool resources in order to achieve business goals that benefit both partners. For example, Viacom (a leading global media company) has a strategic alliance with Beijing Television to produce Chinese-language music and entertainment programming.⁷⁶

An alliance can serve a number of purposes:

1. Enhancing marketing efforts
2. Building sales and market share
3. Improving products
4. Reducing production and distribution costs
5. Sharing technology

Alliances range in scope from informal cooperative agreements to joint ventures—alliances in which the partners fund a separate entity (perhaps a partnership or a corporation) to manage their joint operation. Magazine publisher Hearst, for example, has joint ventures with companies in several countries. So, young women in Israel can read *Cosmo Israel* in Hebrew, and Russian women can pick up a Russian-language version of *Cosmo* that meets their needs. The U.S. edition serves as a starting point to which nationally appropriate material is added in each different nation. This approach allows Hearst to sell the magazine in more than fifty countries.⁷⁷

Foreign Direct Investment and Subsidiaries

Many of the approaches to global expansion that we've discussed so far allow companies to participate in international markets without investing in foreign plants and facilities. As markets expand, however, a firm might decide to enhance its competitive advantage by making a direct investment in operations conducted in another country. Foreign direct investment (FDI) refers to the formal establishment of business operations on foreign soil—the building of factories, sales offices, and distribution networks to serve local markets in a nation other than the company's home country. On the other hand offshoring occurs when the facilities set up in the foreign country replace U.S. manufacturing facilities and are used to produce goods that will be sent back to the United States for sale. Shifting production to low-wage countries is often criticized as it results in the loss of jobs for U.S. workers.⁷⁸

FDI is generally the most expensive commitment that a firm can make to an overseas market, and it's typically driven by the size and attractiveness of the target market. For example, German and Japanese automakers, such as BMW, Mercedes, Toyota, and Honda, have made serious commitments to the U.S. market: most of the cars and trucks that they build in plants in the South and Midwest are destined for sale in the United States.

A common form of FDI is the foreign subsidiary: an independent company owned by a foreign firm (called the *parent*). This approach to going international not only gives the parent company full access to local markets but also exempts it from any laws or regulations that may hamper the activities of foreign firms. The parent company has tight control over the operations of a subsidiary, but while senior managers from the parent company often oversee operations, many managers and employees are citizens of the host country. Not surprisingly, most very large firms have foreign subsidiaries. IBM and Coca-Cola, for example, have both had success in the Japanese market through their foreign subsidiaries (IBM-Japan and Coca-Cola-Japan). FDI goes in the other direction, too, and many companies operating in the United States are in fact subsidiaries of foreign firms. Gerber Products, for example, is a subsidiary of the Swiss company Novartis, while Stop & Shop and Giant Food Stores belong to the Dutch company Royal Ahold.

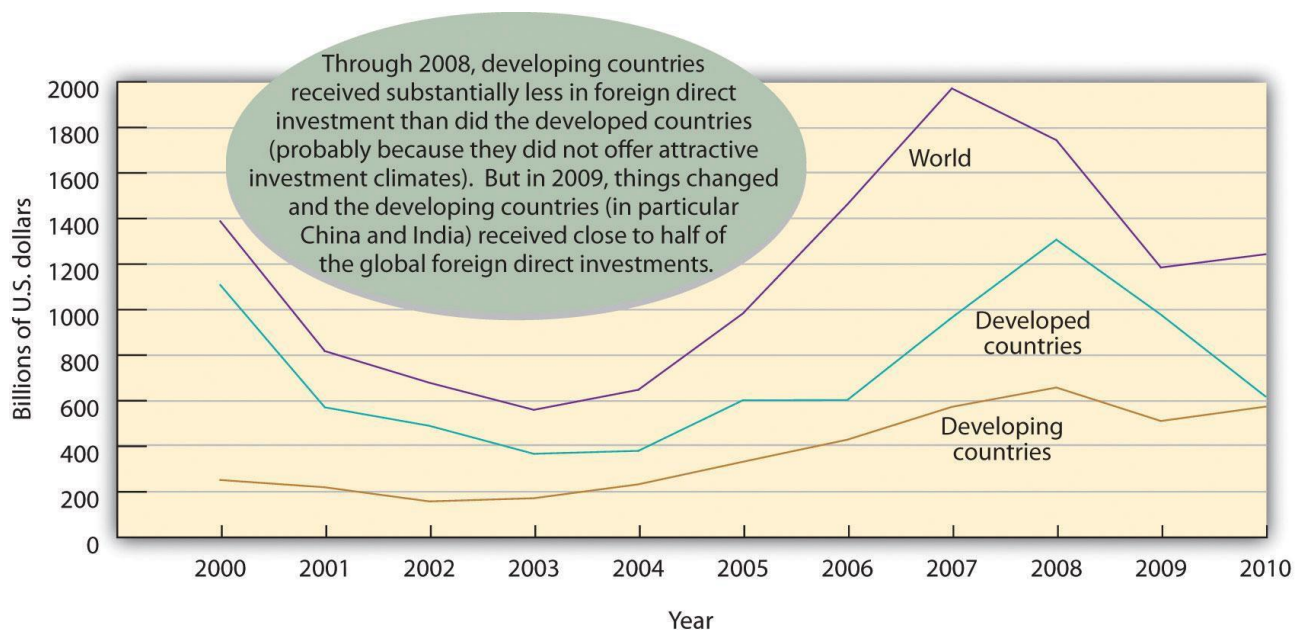


Figure 21 Where FDI Goes

Where does most FDI capital end up? Figure 3 "Where FDI Goes" provides an overview of amounts, destinations (developed or developing countries), and trends.

All these strategies have been successful in the arena of global business. But success in international business involves more than merely finding the best way to reach international markets. Doing global business is a complex, risky endeavor. As many companies have learned the hard way, people and organizations don't do things the same way abroad as they do at home. What differences make global business so tricky? That's the question that we'll turn to next.

Multinational Corporations

A company that operates in many countries is called a multinational corporation (MNC).

Fortune magazine's roster of the top five hundred MNCs in the world speaks for the growth of non-U.S. businesses. Only two of the top ten multinational companies are headquartered in the United States: Wal-Mart (number 1) and Exxon (number 3). Four others are in the second tier (tenth through twentieth): Chevron, General Electric, Bank of America, and ConocoPhillips. The remaining fourteen are non-U.S. firms. Interestingly, of the twenty top companies, nine are energy suppliers, and seven are insurance or financial service firms. Figure 4 "The World's Twenty Largest MNCs" provides a list of these twenty largest MNC's according to revenues.⁷⁹

MNCs often adopt the approach encapsulated in the motto "Think globally, act locally." They often adjust their operations, products, marketing, and distribution to mesh with the environments of the countries in which they operate. Because they understand that a "one-size-fits-all" mentality doesn't make good business sense when they're trying to sell products in different markets, they're willing to accommodate cultural and economic differences. Increasingly, MNCs supplement their mainstream product line with products designed for local markets. Coca-Cola, for example, produces coffee and citrus-juice drinks developed specifically for the Japanese market.⁸⁰ When such companies as Nokia and Motorola design cell phones, they're often geared to local tastes in color, size, and other features. For example, Nokia introduced a cell phone for the rural Indian consumer that has a dust-resistant keypad, antislip grip, and a built-in flashlight.⁸¹ McDonald's provides a vegetarian menu in India, where religious convictions affect the demand for beef and

pork.⁸² In Germany, McDonald's caters to local tastes by offering beer in some restaurants.⁸³ It offers a Maharaja Mac in India, a McItaly Burger in Italy, and a Teriyaki McBurger with Seaweed Shaker Fries in Japan.⁸⁴

Rank	Company	Revenues (in \$ millions)	Country —Type of business
1	Wal-Mart Stores	408,214	US-retailer
2	Royal Dutch Shell	285,129	Netherlands-energy
3	Exxon Mobil	284,650	US-energy
4	BP	246,138	Britain-energy
5	Toyota Motor	204,106	Japan-automobile manufacturer
6	Japan Post Holdings	202,196	Japan-mail delivery, banking and insurance
7	Sinopec	187,518	China-energy
8	State Grid	184,496	China-power grid building and operator
9	AXA	175,257	France-insurance
10	China National Petroleum	165,496	China-energy
11	Chevron	163,527	US-energy
12	ING Group	163,204	Netherlands-financial services
13	General Electric	156,779	US-industrial conglomerate
14	Total	155,887	France-energy
15	Bank of America Corp.	150,450	US-financial services
16	Volkswagen	146,205	Germany-automobile manufacturer
17	ConocoPhillips	139,515	US-energy
18	BNP Paribas	130,708	France - financial services
19	Assicurazioni Generali	126,012	Italy-insurance company
20	Allianz	125,999	Germany-financial services

Figure 22 The World's Twenty Largest MNCs

Likewise, many MNCs have made themselves more sensitive to local market conditions by decentralizing their decision making. While corporate headquarters still maintain a fair amount of control, home-country managers keep a suitable distance by relying on modern telecommunications. Today, fewer managers are dispatched from headquarters; MNCs depend instead on local talent. Not only does decentralized organization speed up and improve decision making, but it also allows an MNC to project the image of a local company. IBM, for instance, has been quite successful in the Japanese market because local customers and suppliers perceive it as a Japanese company. Crucial to this

perception is the fact that the vast majority of IBM's Tokyo employees, including top leadership, are Japanese nationals.⁸⁵

Criticism of MNC Culture

The global reach of MNCs is a source of criticism, as well as praise. Critics argue that they often destroy the livelihoods of home-country workers by moving jobs to developing countries where workers are willing to labor under poor conditions and for less pay. They also contend that traditional lifestyles and values are being weakened, and even destroyed, as global brands foster a global culture of American movies; fast food; and cheap, mass-produced consumer products. Still others claim that the demand of MNCs for constant economic growth and cheaper access to natural resources do irreversible damage to the physical environment. All these negative consequences, critics maintain, stem from the abuses of international trade—from the policy of placing profits above people, on a global scale. These views surfaced in violent street demonstrations in Seattle in 1999 and Genoa, Italy, in 2000, and since then, meetings of the International Monetary Fund and World Bank have regularly been assailed by large crowds of protestors who have succeeded in catching the attention of the worldwide media.

In Defense of MNC Culture

Meanwhile, supporters of MNCs respond that huge corporations deliver better, cheaper products for customers everywhere; create jobs; and raise the standard of living in developing countries. They also argue that globalization increases cross-cultural understanding. Anne O. Kruger, first deputy managing director of the IMF, says the following:

“The impact of the faster growth on living standards has been phenomenal. We have observed the increased well-being of a larger percentage of the world’s population by a greater increment than ever before in history. Growing incomes give people the ability to spend on things other than basic food and shelter, in particular on things such as education and health. This ability, combined with the sharing among nations of medical and scientific advances, has transformed life in many parts of the developing world. Infant mortality has declined from 180 per 1,000 births in

1950 to 60 per 1,000 births. Literacy rates have risen from an average of 40 percent in the 1950s to over 70 percent today. World poverty has declined, despite still-high population growth in the developing world.”⁸⁶

Key Takeaways

- For a company in the United States wishing to expand beyond national borders, there are a variety of ways to get involved in international business.
- **Importing** involves purchasing products from other countries and reselling them in one’s own.
- **Exporting** entails selling products to foreign customers.
- Under a franchise agreement, a company grants a foreign company the right to use its brand name and sell its products.
- A licensing agreement allows a foreign company to sell a company’s products or use its intellectual property in exchange for royalty fees.
- Through international contract manufacturing, or outsourcing, a company has its products manufactured or services provided in other countries.
- A strategic alliance is an agreement between two companies to pool talent and resources to achieve business goals that benefit both partners.
- A joint venture is a specific type of strategic alliance in which a separate entity funded by the participating companies is formed to manage the alliance.
- Foreign direct investment (FDI) refers to the formal establishment of business operations on foreign soil.
- Offshoring occurs when a company sets up facilities in a foreign country that replaces U.S. manufacturing facilities to produce goods that will be sent back to the United States for sale. Shifting production to low-wage countries is often criticized as it results in the loss of jobs for U.S. workers.
- A common form of FDI is the foreign subsidiary, an independent company owned by a foreign firm.
- A company that operates in many countries is called a multinational corporation (MNC).

The Global Business Environment

Learning Outcome

1. Appreciate how cultural, economic, legal, and political differences between countries create challenges to successful business dealings.

In the classic movie *The Wizard of Oz*, a magically misplaced Midwest farm girl takes a moment to survey the bizarre landscape of Oz and then comments to her little dog, “I don’t think we’re in Kansas anymore, Toto.” That sentiment probably echoes the reaction of many businesspeople who find themselves in the midst of international ventures for the first time. The differences between the foreign landscape and the one with which they’re familiar are often huge and multifaceted. Some are quite obvious, such as differences in language, currency, and everyday habits (say, using chopsticks instead of silverware). But others are subtle, complex, and sometimes even hidden. Success in international business means understanding a wide range of cultural, economic, legal, and political differences between countries. Let’s look at some of the more important of these differences.

The Cultural Environment

Even when two people from the same country communicate, there’s always a possibility of misunderstanding. When people from different countries get together, that possibility increases substantially. Differences in communication styles reflect differences in culture: the system of shared beliefs, values, customs, and behaviors that govern the interactions of members of a society. Cultural differences create challenges to successful international business dealings. We explain a few of these challenges in the following sections.

Language

English is the international language of business. The natives of such European countries as France and Spain certainly take pride in their own languages and cultures, but nevertheless English is the business language of the European community. Whereas only a few educated Europeans have studied Italian or Norwegian, most have studied English. Similarly, on the South Asian subcontinent, where hundreds of local languages and dialects are spoken, English is the official language. In most corners of the world, English-only speakers—such as most Americans—have no problem finding competent translators and interpreters. So why is language an issue for English speakers doing business in the

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global marketplace?

In many countries, only members of the educated classes speak English. The larger population—which is usually the market you want to tap—speaks the local tongue. Advertising messages and sales appeals must take this fact into account. More than one English translation of an advertising slogan has resulted in a humorous (and perhaps serious) blunder. Some classics are listed in Table 2 "Lost in Translation".

Lost in Translation

- In Belgium, the translation of the slogan of an American auto-body company, “Body by Fisher,” came out as “Corpse by Fisher.”
- Translated into German, the slogan “Come Alive with Pepsi” became “Come out of the Grave with Pepsi.”
- A U.S. computer company in Indonesia translated “software” as “underwear.”
- A German chocolate product called “Zit” didn’t sell well in the United States.
- An English-speaking car-wash company in Francophone Quebec advertised itself as a “lavement d’auto” (“car enema”) instead of the correct “lavage d’auto.”
- A proposed new soap called “Dainty” in English came out as “aloof” in Flemish (Belgium), “dimwitted” in Farsi (Iran), and “crazy person” in Korea; the product was shelved.
- One false word in a Mexican commercial for an American shirt maker changed “When I used this shirt, I felt good” to “Until I used this shirt, I felt good.”
- In the 1970s, GM’s Chevy Nova didn’t get on the road in Puerto Rico, in part because Nova in Spanish means “It doesn’t go.”
- A U.S. appliance ad fizzled in the Middle East because it showed a well-stocked refrigerator featuring a large ham, thus offending the sensibilities of Muslim consumers, who don’t eat pork.

Furthermore, relying on translators and interpreters puts you as an international businessperson at a disadvantage. You’re privy only to *interpretations* of the messages that you’re getting, and this handicap can result in a real competitive problem. Maybe you’ll misread the subtler intentions of the person with whom you’re trying to conduct business. The best way to combat this problem is to study foreign languages. Most people

appreciate some effort to communicate in their local language, even on the most basic level. They even appreciate mistakes you make resulting from a desire to demonstrate your genuine interest in the language of your counterparts in foreign countries. The same principle goes doubly when you're introducing yourself to non-English speakers in the United States. Few things work faster to encourage a friendly atmosphere than a native speaker's willingness to greet a foreign guest in the guest's native language.

Time and Sociability

Americans take for granted many of the cultural aspects of our business practices. Most of our meetings, for instance, focus on business issues, and we tend to start and end our meetings on schedule. These habits stem from a broader cultural preference: we don't like to waste time. (It was an American, Benjamin Franklin, who coined the phrase "Time is money.") This preference, however, is by no means universal. The expectation that meetings will start on time and adhere to precise agendas is common in parts of Europe (especially the Germanic countries), as well as in the United States, but elsewhere—say, in Latin America and the Middle East—people are often late to meetings.

High- and Low-Context Cultures

Likewise, don't expect businesspeople from these regions—or businesspeople from most of Mediterranean Europe, for that matter—to "get down to business" as soon as a meeting has started. They'll probably ask about your health and that of your family, inquire whether you're enjoying your visit to their country, suggest local foods, and generally appear to be avoiding serious discussion at all costs. For Americans, such topics are conducive to nothing but idle chitchat, but in certain cultures, getting started this way is a matter of simple politeness and hospitality.

If you ever find yourself in such a situation, the best advice is to go with the flow and be receptive to cultural nuances. In high-context cultures, the numerous interlocking (and often unstated) personal and family connections that hold people together have an effect on almost all interactions. Because people's personal lives overlap with their business lives (and vice versa), it's important to get to know your potential business partners as human beings and individuals.

By contrast, in low-context cultures, such as those of the United States, Germany,

Switzerland, and the Scandinavian countries, personal and work relationships are more compartmentalized: you don't necessarily need to know much about the personal context of a person's life to deal with him or her in the business arena.

Intercultural Communication

Different cultures have different communication *styles*—a fact that can take some getting used to. For example, *degrees of animation in expression* can vary from culture to culture. Southern Europeans and Middle Easterners are quite animated, favoring expressive body language along with hand gestures and raised voices. Northern Europeans are far more reserved. The English, for example, are famous for their understated style and the Germans for their formality in most business settings. In addition, the *distance* at which one feels comfortable when talking with someone varies by culture. People from the Middle East like to converse from a distance of a foot or less, while Americans prefer more personal space.

Finally, while people in some cultures prefer to deliver direct, clear messages, others use language that's subtler or more indirect. North Americans and most Northern Europeans fall into the former category and many Asians into the latter. But even within these categories, there are differences. Though typically polite, Chinese and Koreans are extremely direct in expression, while Japanese are indirect: They use vague language and avoid saying “no” even if they do not intend to do what you ask. They worry that turning someone down will result in their “losing face,” and so they avoid doing this in public.

This discussion brings up two important points. First, avoid lumping loosely related cultures together. We sometimes talk, for example, about “Asian culture,” but such broad categories as “Asian” are usually oversimplifications. Japanese culture is different from Korean, which is different from Chinese. Second, never assume that two people from the same culture will always act in a similar manner. Not all Latin Americans are casual about meeting times, not all Italians use animated body language, and not all Germans are formal.

In summary, learn about a country's culture and use your knowledge to help improve the quality of your business dealings. Learn to value the subtle differences among cultures, but don't allow cultural stereotypes to dictate how you interact with people from *any* culture.

Treat each person as an individual and spend time getting to know what he or she is about.

The Economic Environment

If you plan to do business in a foreign country, you need to know its level of economic development. You also should be aware of factors influencing the value of its currency and the impact that changes in that value will have on your profits.

Economic Development

If you don't understand a nation's level of economic development, you'll have trouble answering some basic questions, such as, Will consumers in this country be able to afford the product I want to sell? How many units can I expect to sell? Will it be possible to make a reasonable profit? A country's level of economic development can be evaluated by estimating the annual income earned per citizen. The World Bank, which lends money for improvements in underdeveloped nations, divides countries into four income categories:⁸⁷

- *High income*—\$12,276 or higher (United States, Germany, Japan)
- *Upper-middle income*—\$3,976 to \$12,275 (China, South Africa, Mexico)
- *Lower-middle income*—\$1,006 to \$3,975 (Vietnam, Philippines, India)
- *Low income*—\$1,005 or less (Kenya, Bangladesh, Haiti)

Note that that even though a country has a low annual income per citizen, it can still be an attractive place for doing business. India, for example, is a lower-middle-income country, yet it has a population of a billion, and a segment of that population is well educated—an appealing feature for many business initiatives.

The long-term goal of many countries is to move up the economic development ladder. Some factors conducive to economic growth include a reliable banking system, a strong stock market, and government policies to encourage investment and competition while discouraging corruption. It's also important that a country have a strong *infrastructure*—its systems of communications (telephone, Internet, television, newspapers), transportation (roads, railways, airports), energy (gas and electricity, power plants), and social facilities

(schools, hospitals). These basic systems will help countries attract foreign investors, which can be crucial to economic development.

Currency Valuations and Exchange Rates

If every nation used the same currency, international trade and travel would be a lot easier. Unfortunately, this is not the case. There are about 175 currencies in the world: Some you've heard of, such as the British pound; others are likely unknown to you, such as the *manat*, the official currency of Azerbaijan, a small nation in Southwest Asia. Let's pretend you suddenly find yourself in Azerbaijan and all you have with you is a credit card (which none of the restaurants or hotels will take) and U.S. dollars (which no one wants either). How can you get some Azerbaijani manats so you can buy a good meal and check into a hotel? If it's during the day, you're in luck. Head to the closest bank and ask someone there who speaks English to exchange your dollars for Azerbaijan manats. If you give the bank clerk \$300 (all of your travel money), don't expect to get back 300 manats; the two currencies are not equal. To determine how much Azerbaijan money you'll get in exchange for your \$300, the bank clerk will look up the day's foreign exchange rate—which tells you how much one currency is worth *relative to another currency*.

If today were August 23, 2011, the clerk would find an exchange rate of 1 U.S. dollar equals .79 manats (which means that you get 79 manats for every dollar you give to the bank clerk). In other words, when you hand the clerk your \$300 you'll get back only 235 manats ($.79 \times \$300$). Most likely, the deal does not sound good to you, but you have no choice—that's what the exchange rate is. Plus, you're lucky that it's during the day and the banks are open: sleeping outside in Azerbaijan with an empty stomach doesn't sound like fun, although it would give you time to wonder what would happen if an Azerbaijani traveled to the United States. When the traveler goes to exchange manats for U.S. dollars, he or she will get back \$1.27 for each manat. Exchanging 300 manats for U.S. dollars yields \$381 in U.S. dollars ($1.27097 \times \300). Well, this doesn't sound fair. Why did you receive fewer manats for your U.S. dollars while the Azerbaijan traveler received more dollars for his or her manats? It is because the U.S. dollar is weak relative to the Azerbaijan manat. There are many reasons for the weakness of the U.S. dollar, but one possible culprit is the huge \$14 trillion debt (and rising) carried by the United States. And if you are looking for things to get upset about, your share of this huge U.S. debt is about \$47,000 (and rising).⁸⁸

Now, we'll look at two business examples. First, let's say that your business is importing watches from Switzerland. Because the watchmaker will want to be paid in Swiss francs, you have to figure out how many U.S. dollars you'll need to buy the francs with which to pay the watchmaker. You'd start by finding out the exchange rate between the Swiss franc and the U.S. dollar.

You could simply look in a newspaper or go to any number of Web sites—say, <http://www.oanda.com> to get the current exchange rate. To keep things simple, let's assume that the exchange rate is 1 Swiss franc = US\$1.27 (i.e., 1 Swiss franc is worth \$1.27). Let's also assume that you owe the Swiss watchmaker 1,000 francs. Doing some quick math, you figure that it will take \$1,270 to buy 1,000 francs (1,000 francs \times the exchange rate of 1.27 = \$1,270).

Now let's say that you don't have the cash flow to pay the watchmaker for two weeks. When you check the exchange rate two weeks later, you find that it has gone up to 1 Swiss franc = \$1.37. Are you better off or worse off? It's easy to check: 1,000 francs \times the new exchange rate of 1.37 = \$1,370. You've just learned the hard way that when the value of the franc relative to the dollar goes up, it costs you more to buy something from Switzerland. You probably can't help but wonder what would have happened if the value of the franc relative to the dollar had gone *down*—say, to \$1.17 per franc. At this rate, you'd need only \$1,170 to pay the 1,000 francs (1,000 \times 1.17). In other words, when the value of the franc relative to the dollar drops, it costs less to buy goods from Switzerland. In sum you've learned the following:

- If a foreign currency goes *up* relative to the U.S. dollar, Americans must pay *more* for goods and services purchased from sellers in the country issuing the currency (foreign products are more expensive). This is bad for exporters who have to pay more for the foreign-made goods they buy to bring back to the United States to sell.
- If a foreign currency goes *down* relative to the U.S. dollar, Americans pay *less* for products from the country issuing the currency (foreign products are cheaper).

In the interest of being thorough, let's look at this phenomenon from the perspective of an American seller and a Swiss buyer. First, we need to know the exchange rate for the U.S.

dollar relative to the franc, which happens to be .79 francs = US\$1. This means that if you want to sell something—let’s say your latest painting—for \$1,000 U.S. to an art lover in Switzerland, the Swiss buyer will need only 790 francs to get the \$1,000 needed to pay you. If the exchange rate went up to .89 francs = US\$1, the cost of the painting would be \$890. If the exchange rate went down to .69 francs = US\$1, the cost of the painting would be \$690. So now you also know the following:

- If the U.S. dollar goes *up* relative to a foreign currency, foreign buyers must pay *more* for American goods and services (they become more expensive).
- If the U.S. dollar goes *down* relative to a foreign currency, foreign buyers pay *less* for American products (they become cheaper). This is good for importers as their “cheaper” goods are more attractive to customers in the foreign country.

The Legal and Regulatory Environment

One of the more difficult aspects of doing business globally is dealing with vast differences in legal and regulatory environments. The United States, for example, has an established set of laws and regulations that provide direction to businesses operating within its borders. But because there is no global legal system, key areas of business law—for example, contract provisions and copyright protection—can be treated in different ways in different countries. Companies doing international business often face many inconsistent laws and regulations. To navigate this sea of confusion, American businesspeople must know and follow both U.S. laws and regulations and those of nations in which they operate.

Business history is filled with stories about American companies that have stumbled in trying to comply with foreign laws and regulations. Coca-Cola, for example, ran afoul of Italian law when it printed its ingredients list on the bottle cap rather than on the bottle itself. Italian courts ruled that the labeling was inadequate because most people throw the cap away. In another case, 3M applied to the Japanese government to create a joint venture with the Sumitomo Industrial Group to make and distribute magnetic tape products in Japan. 3M spent four years trying to satisfy Japan’s complex regulations, but by the time it got approval, domestic competitors, including Sony, had captured the market. By delaying 3M, Japanese regulators managed, in effect, to stifle foreign competition.⁸⁹

One approach to dealing with local laws and regulations is hiring lawyers from the host country who can provide advice on legal issues. Another is working with local businesspeople who have experience in complying with regulations and overcoming bureaucratic obstacles.

Foreign Corrupt Practices Act

One U.S. law that creates unique challenges for American firms operating overseas is the Foreign Corrupt Practices Act, which prohibits the distribution of bribes and other favors in the conduct of business. Unfortunately, though they're illegal in this country, such tactics as kickbacks and bribes are business-as-usual in many nations. According to some experts, American businesspeople are at a competitive disadvantage if they're prohibited from giving bribes or undercover payments to foreign officials or businesspeople who expect them; it's like asking for good service in a restaurant when the waiter knows you won't be giving a tip. In theory, because the Foreign Corrupt Practices Act warns foreigners that Americans can't give bribes, they'll eventually stop expecting them.

Where are American businesspeople most likely and least likely to encounter bribe requests and related forms of corruption? Transparency International, an independent German-based organization, annually rates nations according to "perceived corruption," which it defines as "the abuse of public office for private gain." Table 3 "Corruptibility Around the World, 2010" reports a sampling of the 2010 rankings.⁹⁰

Table 3 Corruptibility Around the World, 2010

Rank	Country	CPI Score*
1	Denmark	9.3
1	New Zealand	9.3
1	Singapore	9.3
4	Finland	9.2
4	Sweden	9.2
6	Canada	8.9
15	Germany	7.9
17	Japan	7.8
20	United Kingdom	7.6
22	United States	7.1
98	Mexico	3.1
175	Iraq	1.6
176	Afghanistan	1.4
178	Somalia	1.1
*A score of 10 means that a country is squeaky clean. Anything under 3 means that corruption is rampant.		

Key Takeaways

- Success in international business means understanding an assortment of cultural, economic, and legal differences between countries.
- Cultural challenges stem from differences in language, concepts of time and sociability, and communication styles.
- If you do business in a foreign country, you need to know the country's level of economic development.
- In dealing with countries whose currency is different from yours, you have to be aware of the impact that fluctuations in **exchange rates** will have on your profits.
- Finally, in doing business globally, you must deal with the challenges that come from the vast differences in legal and regulatory environments.

Chapter 3 Review Questions

Multiple Choice:

- We determine a country's _____ by subtracting the value of its imports from the value of its exports
 1. balance of trade
 2. trade surplus
 3. trade deficit
 4. balance of payments
- Over a period, _____ is the difference between the total flow coming into a country and the total flow going out.
 1. balance of trade
 2. trade surplus
 3. trade deficit
 4. balance of payments
- Viacom has a _____ with Beijing Television to produce music and entertainment.
 1. License agreement
 2. Foreign direct investment
 3. Strategic alliance
 4. Joint venture
- _____ is generally the most expensive commitment that a firm can make to an overseas market.
 1. License agreement
 2. Foreign direct investment
 3. Strategic alliance
 4. Joint venture
- Which is not one of the three differences to understand between countries in order to be successful in international business?
 1. Cultural
 2. Social
 3. Economic
 4. Legal

Short Answer:

1. What is the difference between Absolute and Comparative Advantage?
2. Explain the three criticisms of Multinational Corporations.
3. Define high-context and low-context cultures.

Chapter 4 Selecting a Form of Business Ownership

Factors to Consider

Learning Outcome

1. Identify the questions to ask in choosing the appropriate form of ownership for a business.

If you're starting a new business, you have to decide which legal form of ownership is best for you and your business. Do you want to own the business yourself and operate as a sole proprietorship? Or, do you want to share ownership, operating as a partnership or a corporation? Before we discuss the pros and cons of these three types of ownership—sole proprietorship, partnership, and corporation—let's address some of the questions that you'd probably ask yourself in choosing the appropriate legal form for your business.

1. What are you willing to do to set up and operate your business? Do you want to minimize the costs of getting started? Do you hope to avoid complex government regulations and reporting requirements?
2. How much control would you like? Do you want to own the company yourself, or do you want to share ownership with other people? Are you willing to share responsibility for running the business?
3. Do you want to be the sole benefactor of your efforts or are you willing to share profits with other people? Do you want to be in charge of deciding how much of the company's profits will be retained in the business?
4. Do you want to avoid special taxes? Do you want to avoid paying "business" income taxes on your business and then paying "personal" income taxes on profits earned by the business?
5. Do you have all the skills needed to run the business? Do you possess the talent

and skills to run the business yourself, or would the business benefit from a diverse group of owners? Are you likely to get along with co-owners over an extended period of time?

6. Should it be possible for the business to continue without you? Is it important to you that the business survive you? Do you want to know that other owners can take over if you die or become disabled? Do you want to make it easy for ownership to change hands?
7. What are your financing needs? How do you plan to finance your company? Will you need a lot of money to start, operate, and grow your business? Can you furnish the money yourself, or will you need some investment from other people? Will you need bank loans? If so, will you have difficulty getting them yourself?
8. How much liability exposure are you willing to accept? Are you willing to risk your personal assets—your bank account, your car, maybe even your home—for your business? Are you prepared to pay business debts out of your personal funds? Do you feel uneasy about accepting personal liability for the actions of fellow owners?

No single form of ownership will give you everything you desire. You'll have to make some trade-offs. Because each option has both advantages and disadvantages, your job is to decide which one offers the features that are most important to you. In the following sections we'll compare the three ownership options (sole proprietorship, partnership, and corporation) on the eight dimensions that we identified previously: setup costs and government regulations control, profit sharing, income taxes, skills, continuity and transferability, ability to obtain financing, and liability exposure.

Key Takeaways

- Some of the questions that you'd probably ask yourself in choosing the appropriate legal form for your business include the following:
 1. *What are you willing to do to set up and operate your business?*
 2. *How much control do you want?*
 3. *Do you want to share profits with others?*

4. *Do you want to avoid special taxes on your business?*
5. *Do you have all the skills needed to run the business?*
6. *Should it be possible for the business to continue without you?*
7. *What are your financing needs?*
8. *How much liability exposure are you willing to accept?*

- No single form of ownership—sole proprietorship, partnership, or corporation—will give you everything you want. Each has advantages and disadvantages.

Sole Proprietorship

Learning Outcome

1. Describe the sole proprietorship form of organization, and specify its advantages and disadvantages.

A sole proprietorship is a business owned by only one person. The most common form of ownership, it accounts for about 72 percent of all U.S. businesses.⁹¹ It's the easiest and cheapest type of business to form: if you're using your own name as the name of your business, you just need a license to get started, and once you're in business, you're subject to few government regulations.

Advantages and Disadvantages of Sole Proprietorships

As sole owner, you have complete control over your business. You make all important decisions, and you're generally responsible for all day-to-day activities. In exchange for assuming all this responsibility, you get all the income earned by the business. Profits earned are taxed as personal income, so you don't have to pay any special federal and state income taxes.

For many people, however, the sole proprietorship is not suitable. The flip side of enjoying complete control, for example, is having to supply all the different talents that may be necessary to make the business a success. And if you die, the business dissolves. You also have to rely on your own resources for financing: in effect, you *are* the business, and any money borrowed by the business is loaned to *you personally*. Even more important, the sole proprietor bears unlimited liability for any losses incurred by the business. As you

can see from Figure 1 "Sole Proprietorship and Unlimited Liability", the principle of unlimited personal liability means that if the *company* incurs a debt or suffers a catastrophe (say, getting sued for causing an injury to someone), the *owner* is personally liable. As a sole proprietor, you put your personal assets (your bank account, your car, maybe even your home) at risk for the sake of your business. You can lessen your risk with insurance, yet your liability exposure can still be substantial. Given that Ben and Jerry decided to start their ice cream business together (and therefore the business was not owned by only one person), they could not set their company up as a sole proprietorship.

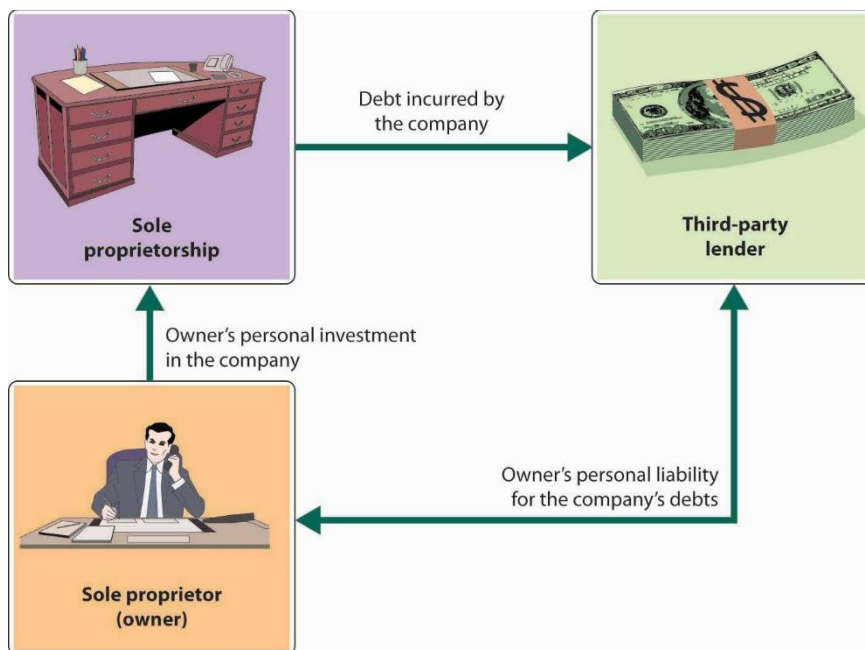


Figure 23 Sole Proprietorship and Unlimited Liability

Key Takeaways

- A **sole proprietorship** is a business owned by only one person.
- It's the most common form of ownership and accounts for about 72 percent of all U.S. businesses.
- Advantages of a sole proprietorship include the following:
 1. Easy and inexpensive to form; few government regulations
 2. Complete control over your business
 3. Get all the profits earned by the business
 4. Don't have to pay any special income taxes

- Disadvantages of a sole proprietorship include the following:
 1. Have to supply all the different talents needed to make the business a success
 2. If you die, the business dissolves
 3. Have to rely on your own resources for financing
 4. If the company incurs a debt or suffers a catastrophe, you are personally liable (you have unlimited liability)

Partnership

Learning Outcomes

1. Identify the different types of partnerships, and explain the importance of a partnership agreement.
2. Describe the advantages and disadvantages of the partnership form of organization.

A partnership (or general partnership) is a business owned jointly by two or more people. About 10 percent of U.S. businesses are partnerships,⁹² and though the vast majority are small, some are quite large. For example, the big four public accounting firms are partnerships. Setting up a partnership is more complex than setting up a sole proprietorship, but it's still relatively easy and inexpensive. The cost varies according to size and complexity. It's possible to form a simple partnership without the help of a lawyer or an accountant, though it's usually a good idea to get professional advice. Professionals can help you identify and resolve issues that may later create disputes among partners.

The Partnership Agreement

The impact of disputes can be lessened if the partners have executed a well-planned *partnership agreement* that specifies everyone's rights and responsibilities. The agreement might provide such details as the following:

- Amount of cash and other contributions to be made by each partner
- Division of partnership income (or loss)
- Partner responsibilities—who does what

- Conditions under which a partner can sell an interest in the company
- Conditions for dissolving the partnership
- Conditions for settling disputes

Unlimited Liability and the Partnership

Figure 2 "General Partnership and Unlimited Liability" shows that a major problem with

partnerships, as with sole proprietorships, is unlimited liability: each partner is personally liable not only for his or her own actions but also for *the actions of all the partners*. In a partnership, it may work according to the following scenario. Say that you're a partner in a dry cleaning business. One day, you return from lunch to find your establishment on fire. You're intercepted by your partner, who tells you that the fire started because he fell asleep while smoking. As you watch your

livelihood go up in flames, your partner tells you something else: because he forgot to pay the bill, your fire insurance was canceled. When it's all over, you estimate the loss to the building and everything inside at \$1.2 million. And here's the really bad news: if the business doesn't have the cash or other assets to cover losses, *you can be personally sued for the amount owed*. In other words, any party who suffered a loss because of the fire can go after your personal assets.

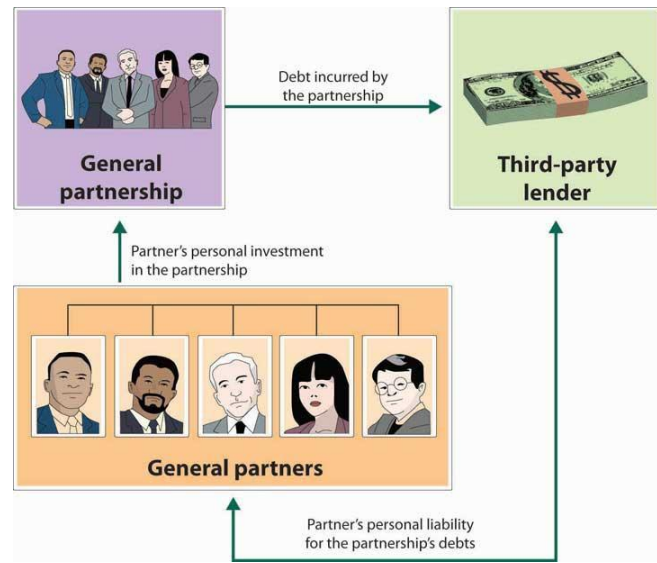


Figure 24 General Partnership and Unlimited Liability

Limited Partnerships

Many people are understandably reluctant to enter into partnerships because of unlimited liability. Individuals with substantial assets, for example, have a lot to lose if they get sued for a partnership obligation (and when people sue, they tend to start with the richest partner). To overcome this defect of partnerships, the law permits a limited partnership, which has two types of partners: a single *general partner* who runs the business and is responsible for its liabilities, and any number of *limited partners* who have limited involvement in the business and whose losses are limited to the amount of their

investment.

Advantages and Disadvantages of Partnerships

The partnership has several advantages over the sole proprietorship. First, it brings together a diverse group of talented individuals who share responsibility for running the business. Second, it makes financing easier: The business can draw on the financial resources of a number of individuals. The partners not only contribute funds to the business but can also use personal resources to secure bank loans. Finally, continuity needn't be an issue because partners can agree legally to allow the partnership to survive if one or more partners die.

Still, there are some negatives. First, as discussed earlier, partners are subject to unlimited liability. Second, being a partner means that you have to share decision making, and many people aren't comfortable with that situation. Not surprisingly, partners often have differences of opinion on how to run a business, and disagreements can escalate to the point of actual conflict; in fact, they can even jeopardize the continuance of the business. Third, in addition to sharing ideas, partners also share profits. This arrangement can work as long as all partners feel that they're being rewarded according to their efforts and accomplishments, but that isn't always the case. While the partnership form of ownership is viewed negatively by some, it was particularly appealing to Ben Cohen and Jerry Greenfield. Starting their ice cream business as a partnership was inexpensive and let them combine their limited financial resources and use their diverse skills and talents. As friends they trusted each other and welcomed shared decision making and profit sharing. They were also not reluctant to be held personally liable for each other's actions.

Key Takeaways

- A general partnership is a business owned jointly by two or more people.
- About 10 percent of U.S. businesses are partnerships.
- The impact of disputes can be reduced if the partners have a partnership agreement that specifies everyone's rights and responsibilities.
- A partnership has several advantages over a sole proprietorship:
 - It's relatively inexpensive to set up and subject to few government regulations.

- Partners pay personal income taxes on their share of profits; the partnership doesn't pay any special taxes.
- It brings a diverse group of people together to share managerial responsibilities.
- Partners can agree legally to allow the partnership to survive if one or more partners die.
- It makes financing easier because the partnership can draw on resources from a number of partners.
- A partnership has several disadvantages over a sole proprietorship:
 - Shared decision making can result in disagreements.
 - Profits must be shared.
 - Each partner is personally liable not only for his or her own actions but also for those of all partners—a principle called **unlimited liability**.
- A **limited partnership** has a single general partner who runs the business and is responsible for its liabilities, plus any number of limited partners who have limited involvement in the business and whose losses are limited to the amount of their investment.

Corporation

Learning Outcomes

1. Explain how corporations are formed and how they operate.
2. Discuss the advantages and disadvantages of the corporate form of ownership.

A corporation (sometimes called a *regular* or C-corporation) differs from a sole proprietorship and a partnership because it's a legal entity that is entirely separate from the parties who own it. It can enter into binding contracts, buy and sell property, sue and be sued, be held responsible for its actions, and be taxed. As Figure 4.5 "Types of U.S. Businesses" shows, corporations account for 18 percent of all U.S. businesses but generate almost 82 percent of the revenues.⁹³ Most large well-known businesses are corporations, but so are many of the smaller firms with which you do business.⁹⁴

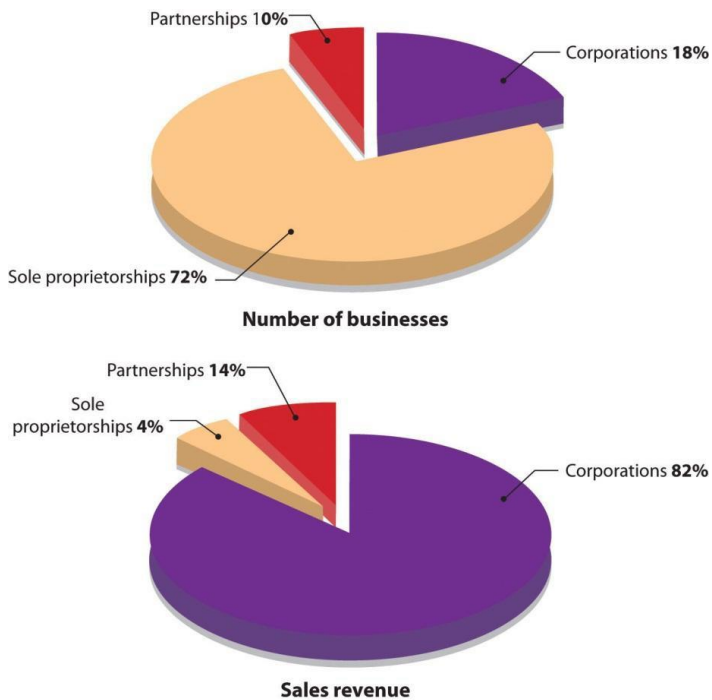


Figure 25 Types of U.S. Businesses

Ownership and Stock

Corporations are owned by shareholders who invest money in the business by buying shares of stock. The portion of the corporation they own depends on the percentage of stock they hold. For example, if a corporation has issued 100 shares of stock, and you own 30 shares, you own 30 percent of the company. The shareholders elect a board of directors, a group of people (primarily from outside the corporation) who are legally responsible for governing the

corporation. The board oversees the major policies and decisions made by the corporation, sets goals and holds management accountable for achieving them, and hires and evaluates the top executive, generally called the CEO (chief executive officer). The board also approves the distribution of income to shareholders in the form of cash payments called dividends.

Benefits of Incorporation

The corporate form of organization offers several advantages, including limited liability for shareholders, greater access to financial resources, specialized management, and continuity.

Limited Liability

The most important benefit of incorporation is the limited liability to which shareholders are exposed: they are not responsible for the obligations of the corporation, and they can lose *no more than the amount that they have personally invested in the company*. Clearly, limited liability would have been a big plus for the unfortunate individual whose business partner burned down their dry cleaning establishment. Had they been incorporated, the *corporation* would have been liable for the debts incurred by the fire. If the corporation didn't have enough money to pay the debt, the individual shareholders would not have

been obligated to pay anything. True, they would have lost all the money that they'd invested in the business, but no more.

Financial Resources

Incorporation also makes it possible for businesses to raise funds by selling stock. This is a big advantage as a company grows and needs more funds to operate and compete. Depending on its size and financial strength, the corporation also has an advantage over other forms of business in getting bank loans. An established corporation can borrow its own funds, but when a small business needs a loan, the bank usually requires that it be guaranteed by its owners.

Specialized Management

Because of their size and ability to pay high sales commissions and benefits, corporations are generally able to attract more skilled and talented employees than are proprietorships and partnerships.

Continuity and Transferability

Another advantage of incorporation is continuity. Because the corporation has a legal life separate from the lives of its owners, it can (at least in theory) exist forever. Transferring ownership of a corporation is easy: shareholders simply sell their stock to others. Some founders, however, want to restrict the transferability of their stock and so choose to operate as a privately-held corporation. The stock in these corporations is held by only a few individuals, who are not allowed to sell it to the general public. Companies with no such restrictions on stock sales are called public corporations; stock is available for sale to the general public.

Drawbacks to Incorporation

Like sole proprietorships and partnerships, corporations have both positive and negative properties. In sole proprietorships and partnerships, for instance, the individuals who own and manage a business are the same people. Corporate managers, however, don't necessarily own stock, and shareholders don't necessarily work for the company. This situation can be troublesome if the goals of the two groups differ significantly. Managers, for example, might be more interested in career advancement than the overall profitability of the company. Stockholders might care about profits without regard for the well-being of

employees.

Another drawback to incorporation—one that often discourages small businesses from incorporating—is the fact that corporations are costly to set up. When you combine filing and licensing fees with accounting and attorney fees, incorporating a business could set you back by \$1,000 to \$6,000 or more depending on the size and scope of your business.⁹⁵ Additionally, corporations are subject to levels of regulation and governmental oversight that can place a burden on small businesses. Finally, corporations are subject to what’s generally called “double taxation.” Corporations are taxed by the federal and state governments on their earnings. When these earnings are distributed as dividends, the shareholders pay taxes on these dividends. Corporate profits are thus taxed twice—the corporation pays the taxes the first time and the shareholders pay the taxes the second time.

Five years after starting their ice cream business, Ben Cohen and Jerry Greenfield evaluated the pros and cons of the corporate form of ownership, and the “pros” won. The primary motivator was the need to raise funds to build a \$2 million manufacturing facility. Not only did Ben and Jerry decide to switch from a partnership to a corporation, but they also decided to sell shares of stock to the public (and thus become a public corporation). Their sale of stock to the public was a bit unusual: Ben and Jerry wanted the community to own the company, so instead of offering the stock to anyone interested in buying a share, they offered stock to residents of Vermont only. Ben believed that “business has a responsibility to give back to the community from which it draws its support.”⁹⁶ He wanted the company to be owned by those who lined up in the gas station to buy cones. The stock was so popular that one in every hundred Vermont families bought stock in the company.⁹⁷ Eventually, as the company continued to expand, the stock was sold on a national level.

Key Takeaways

- A **corporation** (sometimes called a *regular* or C-corporation) is a legal entity that's separate from the parties who own it.
- Corporations are owned by **shareholders** who invest money in them by buying shares of **stock**.

- They elect a **board of directors** that's legally responsible for governing the corporation.
- A corporation has several advantages over a sole proprietorship and partnership:
 - An important advantage of incorporation is **limited liability**: Owners are not responsible for the obligations of the corporation and can lose no more than the amount that they have personally invested in the company.
 - Incorporation also makes it easier to access financing.
 - Because the corporation is a separate legal entity, it exists beyond the lives of its owners.
- Corporations are generally able to attract skilled and talented employees. A corporation has several disadvantages over a sole proprietorship and partnership:
 - The goals of corporate managers, who don't necessarily own stock, and shareholders, who don't necessarily work for the company, can differ.
 - It's costly to set up and subject to burdensome regulations and government oversight.
 - It's subject to "double taxation." Corporations are taxed on their earnings. When these earnings are distributed as dividends, the shareholders pay taxes on these dividends.

Other Types of Business Ownership

Learning Outcome

1. Examine special types of business ownership, including S-corporations, limited-liability companies, cooperatives, and not-for-profit corporations.

In addition to the three commonly adopted forms of business organization—sole proprietorship, partnership, and regular corporations—some business owners select other forms of organization to meet their particular needs. We'll look at several of these options:

- S-corporations
- Limited-liability companies
- Cooperatives
- Not-for-profit corporations

Hybrids: S-Corporations and Limited-Liability Companies

To understand the value of S-corporations and limited-liability companies, we'll begin by reviewing the major advantages and disadvantages of the three types of business ownership we've explored so far: sole proprietorship, partnership, and corporation. Identifying the attractive and unattractive features of these three types of business ownership will help us appreciate why S-corporations and limited-liability companies were created.

Attractive and Unattractive Features of Corporations

What feature of corporations do business owners find **most attractive**? The most attractive feature of a corporation is limited liability, which means that the shareholders (owners) cannot be held personally liable for the debts and obligations of the corporation. For example, if a corporation cannot pay its debts and goes bankrupt, the shareholders will not be required to pay the creditors with their own money. Shareholders cannot lose any more than the amount they have invested in the company.

What feature of corporations do business owners find **least attractive**? Most would agree that the least attractive feature of a corporation is “double taxation.” Double taxation occurs when the same earnings are taxed twice by the government. Let's use a simple example to show how this happens. You're the only shareholder in a very small corporation. This past year it earned \$10,000. It had to pay the government \$3,000 corporate tax on the

\$10,000 earned. The remaining \$7,000 was paid to you by the corporation in the form of a dividend. When you filed your personal income tax form, you had to pay personal taxes on the \$7,000 dividend. So the \$7,000 was taxed twice: the corporation paid the taxes the first time and you (the shareholder) paid the taxes the second time.

Attractive and Unattractive Features of Sole Proprietorships and Partnerships

Now let's turn to the other two types of business ownership: sole proprietorship and partnership. What feature of these forms of business organization do owners find **most attractive**? The most attractive feature is that there is **no** "double taxation" with proprietorships and partnerships. Proprietorships and partnerships do not pay taxes on profits at the business level. The only taxes paid are at the personal level—this occurs when proprietors and partners pay taxes on their share of their company's income. Here are two examples (one for a sole proprietorship and one for a partnership). First, let's say you're a sole proprietor and your business earns \$20,000 this year. The sole proprietorship pays no taxes at the "business" level. You pay taxes on the \$20,000 earnings on your personal tax return. Second, let's say you're a partner in a three-partner firm (in which each partner receives one-third of the partnership income). The firm earns \$90,000 this year. It pays no taxes at the partnership level. Each partner, including you, pays taxes on one-third of the earnings, or \$30,000 each. Notice that in both cases, there is no "double taxation." Taxes were paid on the company earnings only once—at the personal level. So the total tax burden is less with sole proprietorships and partnerships than it is with corporations.

What feature of sole proprietorships and partnerships do business owners find **least attractive**? And the answer is...unlimited liability. This feature holds a business owner personally liable for all debts of his or her company. If you're a sole proprietorship and the debts of your business exceed its assets, creditors can seize your personal assets to cover the proprietorship's outstanding business debt. For example, if your business is sued for \$500,000 and it does not have enough money to cover its legal obligation, the injured party can seize your personal assets (cash, property, etc.) to cover the outstanding debt. Unlimited liability is even riskier in the case of a partnership. Each partner is personally liable not only for his or her own actions but also for the actions of all the partners. If,

through mismanagement by one of your partners, the partnership is forced into bankruptcy, the creditors can go after you for all outstanding debts of the partnership.

The Hybrids

How would you like a legal form of organization that provides the attractive features of the three common forms of organization (corporation, sole proprietorship and partnership) and avoids the unattractive features of these three organization forms? It sounds very appealing. This is what was accomplished with the creation of two hybrid forms of organization: S-corporation and limited-liability company. These hybrid organization forms provide business owners with limited liability (the attractive feature of corporations) and no “double taxation” (the attractive feature of sole proprietorships and partnerships). They avoid double taxation (the unattractive feature of corporations) and unlimited liability (the unattractive feature of sole proprietorships and partnerships). We’ll now look at these two hybrids in more detail.

S-Corporation

In 1970, Karen and Mike Tocci, avid go-kart racing fans, bought a parcel of land in New Hampshire so their son, Rob, and his son’s friends could drag race in a safe environment. The Tocci’s continued interest in racing resulted in their starting a family-run business called Shannon Dragway. Over time, the business expanded to include a speedway track and a go-kart track and was renamed New Hampshire Motorsports Complex. In selecting their organization form, the Tocci’s wanted to accomplish two main goals: (1) limit their personal liability; and (2) avoid having their earnings taxed twice, first at the corporate level and again at the personal level. An S-corporation form of business achieved these goals. They found they were able to meet the following S-corporation eligibility criteria:

- The company has no more than 100 shareholders
- All shareholders are individuals, estates, or certain nonprofits or trusts
- All shareholders are U.S. citizens and permanent residents of the U.S.
- The business is not a bank or insurance company
- All shareholders concur with the decision to form an S-corporation

Deciding to operate as an S-corporation presented the Tocci’s with some disadvantages: They had no flexibility in the way profits were divided among the owners. In an S-

corporation, profits must be allocated based on percentage ownership. So if an owner/shareholder holds 25 percent of the stock in the S-corporation, 25 percent of the company profits are allocated to this shareholder regardless of the amount of effort he or she exerts in running the business. Additionally, the owners had to follow a number of formal procedures, such as electing a board of directors and holding annual meetings. Finally, they were subjected to heavy recordkeeping requirements. Despite these disadvantages, the Tocci's concluded that on balance the S-corporation was the best form of organization for their business.

Limited-Liability Company

In 1977, Wyoming was the first state to allow businesses to operate as limited-liability companies. Twenty years later, in 1997, Hawaii was the last state to give its approval to the new organization form. Since then, the limited-liability company has increased in popularity. Its rapid growth was fueled in part by changes in state statutes that permit a limited-liability company to have just one member. The trend to LLCs can be witnessed by reading company names on the side of trucks or on storefronts in your city. It is common to see names such as Jim Evans Tree Care, LLC, and For-Cats-Only Veterinary Clinic, LLC. But LLCs are not limited to small businesses. Companies such as Crayola, Domino's Pizza, Ritz-Carlton Hotel Company, and iSold It (which helps people sell their unwanted belongings on eBay) are operating under the limited-liability form of organization.

In many ways, a limited-liability company looks a lot like an S-corporation. Its owners (called members rather than shareholders) are not personally liable for debts of the company, and its earnings are taxed only once, at the personal level (thereby eliminating double taxation). But there are important differences between the two forms of organizations. For example, an LLC:

- Has fewer ownership restrictions. It can have as many members as it wants—it is not restricted to a maximum of 100 shareholders.
- Its members don't have to be U.S. residents or citizens.
- Profits do not have to be allocated to owners based on percentage ownership. Members can distribute profits in any way they want.
- Is easier to operate because it doesn't have as many rules and restrictions as does

an S-corporation. It doesn't have to elect a board of directors, hold annual meetings, or contend with a heavy recordkeeping burden.

As the approach used to allocate profits is very important (item 3 described previously), let's spend a few minutes going over an example of how the profit allocation process works. Let's say that you and a business partner started a small pet grooming business at the beginning of the year. Your business partner (who has more money than you do) contributed \$40,000 to start-up the business and you contributed \$10,000 (so your partner's percentage ownership in the business is 80 percent and yours is 20 percent). But your business partner has another job and so you did 90 percent of the work during the past year. Profit for the first year was \$100,000. If your company was set up as a S-corporation, you would be required to allocate profits based on percentage ownership. Under this allocation scheme \$80,000 of the profits would be allocated to your business partner and only \$20,000 would be allocated to you. This hardly seems fair. Under the limited-liability form of organization you and your partner can decide what a "fair" allocation of profits is and split the profits accordingly. Perhaps you will decide that you should get 70 percent of the profits (or \$70,000) and your business partner should get 30 percent (or \$30,000).

Now, let's look at the fourth item—ease of operation. It is true that S-corporations have to deal with more red tape and paperwork and abide by more rules (such as holding annual meetings) than do limited-liability companies. Plus they are more complex to set up. But this does not mean that setting up and operating a limited-liability company is a breeze and should be taken lightly. One essential task that should be carefully attended to is the preparation of an operating agreement. This document, which is completed when the company is formed (and can be revised later), is essential to the success of the business. It describes the rights and responsibilities of the LLC members and spells out how profits or losses will be allocated.

We have touted the benefits of limited liability protection for an LLC (as well as for regular corporations and S-corporations). We now need to point out some circumstances under which an LLC member (or shareholder in a corporation) might be held personally liable for the debts of his or her company. A business owner can be held personally liable if he or

she:

1. Personally guarantees a business debt or bank loan which the company fails to pay
2. Fails to pay employment taxes to the government that were withheld from workers' wages
3. Engages in fraudulent or illegal behavior that harms the company or someone else
4. Does not treat the company as a separate legal entity, for example, uses company assets for personal uses

As personal loan guarantees are the most common circumstance under which an LLC member is held personally liability for the debts of his or her company, let's explore this topic some more by asking (and answering) two questions:

1. **What is a loan guarantee?** It is a legal agreement made between an individual and a bank that says, "If my company does not repay this loan, I will." It is the same thing as co-signing a loan.
2. **Why would an LLC member give a bank a personal guarantee?** Because it is often the only way a business can get a loan. Bankers understand the concept of limited liability. They know that if the company goes out of business (and the loan is not guaranteed), the bank is stuck with an unpaid loan because the LLC members are not personally liability for the debts of the company. Consequently, banks are reluctant to give loans to companies (particularly those just starting up) unless the loans are guaranteed by an owner.

A final note about hybrid forms of organization. In this section, we have looked at two organization forms that offer business owners limited liability and tax benefits. There are others not covered here such as Professional Limited-Liability Companies (PLLCs), which are set up by doctors, lawyers, accountants, and so on who provide professional services. And it is evident that the variations of organization forms available to businesses will continue to expand in the future.

Cooperatives

A cooperative (also known as a co-op) is a business owned and controlled by those who use its services. Individuals and firms who belong to the cooperative join together to

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market products, purchase supplies, and provide services for its members. If run correctly, cooperatives increase profits for its producer-members and lower costs for its consumer-members. Cooperatives are common in the agricultural community. For example, some 750 cranberry and grapefruit member growers market their cranberry sauce, fruit juices, and dried cranberries through the Ocean Spray Cooperative.⁹⁸ More than three hundred thousand farmers obtain products they need for production—feed, seed, fertilizer, farm supplies, fuel—through the Southern States Cooperative.⁹⁹ Co-ops also exist outside agriculture. For example, REI (Recreational Equipment Incorporated), which sells quality outdoor gear, is the largest consumer cooperative in the United States with more than three million active members. The company shares its financial success each year with its members, who get a refund each year based on their eligible purchases.¹⁰⁰

Not-for-Profit Corporations

A not-for-profit corporation (sometimes called a nonprofit) is an organization formed to serve some public purpose rather than for financial gain. As long as the organization's activity is for charitable, religious, educational, scientific, or literary purposes, it should be exempt from paying income taxes. Additionally, individuals and other organizations that contribute to the not-for-profit corporation can take a tax deduction for those contributions. The types of groups that normally apply for nonprofit status vary widely and include churches, synagogues, mosques, and other places of worship; museums; schools; and conservation groups.

There are more than 1.5 million not-for-profit organizations in the United States.¹⁰¹ Some are extremely well funded, such as the Bill and Melinda Gates Foundation, which has an endowment of approximately \$38 billion and has given away \$25.36 billion since its inception.¹⁰² Others are nationally recognized, such as United Way, Goodwill Industries, Habitat for Humanity, and the Red Cross. Yet the vast majority is neither rich nor famous, but nevertheless makes significant contributions to society.

Key Takeaways

- The **S-corporation** gives small business owners limited liability protection, but taxes company profits only once, when they are paid out as dividends. It can't have more than one hundred stockholders.
- A **limited-liability company** (LLC) is similar to an S-corporation: its members are not personally liable for company debts and its earnings are taxed only once, when they're paid out as dividends. But it has fewer rules and restrictions than does an S- corporation. For example, an LLC can have any number of members.
- A **cooperative** is a business owned and controlled by those who use its services. Individuals and firms who belong to the cooperative join together to market products, purchase supplies, and provide services for its members.
- A **not-for-profit corporation** is an organization formed to serve some public purpose rather than for financial gain. It enjoys favorable tax treatment.

Chapter 4 Review Questions

Multiple Choice:

- This type of business represents 82% of U.S. Sales Revenue.
 1. sole proprietorship
 2. partnership
 3. corporation
- In this type of business, owners have unlimited liability.
 1. sole proprietorship
 2. S-corporation
 3. corporation
- This type of business is subject to double taxation.
 1. sole proprietorship
 2. partnership
 3. corporation
- This type of business cannot have more than 100 shareholders.
 1. S-corporations
 2. Limited-liability companies
 3. Cooperatives
 4. Not-for-profit corporations
- This type of business is owned and controlled by those who use its services.
 1. S-corporations
 2. Limited-liability companies
 3. Cooperatives
 4. Not-for-profit corporations

Short Answer:

1. What are four advantages of a sole proprietorship? Five advantages of a partnership? Four advantages of a corporation?
2. What is a not-for-profit corporation?

Chapter 5 The Challenges of Starting a Business

What Is an Entrepreneur?

Learning Outcomes

1. Define entrepreneur.
2. Describe the three characteristics of entrepreneurial activity.
3. Identify five potential advantages to starting your own business.
4. Explain the differences among three types of start-up firms.

In developing BTIO and Realityworks Inc., the Jurmains were doing what entrepreneurs do (and doing it very well). In fact, Mary was nominated three times for the Ernst & Young Entrepreneur of the Year Award and named 2001 Wisconsin Entrepreneurial Woman of the Year by the National Association of Women Business Owners. So what, exactly, is an *entrepreneur*? What does an entrepreneur do? According to one definition, an entrepreneur is an “individual who starts a new business,” and that’s true as far as it goes. Another definition identifies an entrepreneur as someone who uses “resources to implement innovative ideas for new, thoughtfully planned ventures,”¹⁰³ which is also true as far as it goes. But an important component of a satisfactory definition is still missing. To appreciate fully what it is, let’s go back to the story of the Jurmains, for whom entrepreneurship seems to have worked out quite well. We hasten to point out that, in 1993, the Jurmains were both unemployed—Rick had been laid off by General Dynamics Corp., and Mary by the San Diego Gas and Electric Company. While they were watching the show about teenagers and flour sacks, they were living off a loan from her father and the returns from a timely investment in coffee futures. Rick recalls that the idea for a method of creating BTIO came to him while “I was awake in bed, worrying about being unemployed.” He was struggling to find a way to feed his family. He had to make the first forty simulators himself, and at the end of the first summer, BTIO had received about four hundred orders—a promising start, perhaps, but, at \$250 per baby (less expenses), not exactly a windfall. “We were always about one month away from bankruptcy,” recalls Mary.

At the same time, it's not as if the Jurmains started up BTIO simply because they had no "conventional" options for improving their financial prospects. Rick, as we've seen, was an aerospace engineer, and his résumé includes work on space-shuttle missions at NASA. Mary, who has not only a head for business but also a degree in industrial engineering, has worked at the Johnson Space Center. Therefore, the idea of replacing a sack of flour with a computer-controlled simulator wasn't necessarily rocket science for the couple. But taking advantage of that idea—choosing to start a new business and to commit themselves to running it—was a risk. *Risk taking* is the missing component that we're looking for in a definition of *entrepreneurship*, and so we'll define an entrepreneur as someone who identifies a business opportunity and assumes *the risk of creating and running a business* to take advantage of it.

The Nature of Entrepreneurship

If we look a little more closely at the definition of entrepreneurship, we can identify three characteristics of entrepreneurial activity:¹⁰⁴

1. *Innovation*. Entrepreneurship generally means offering a new product, applying a new technique or technology, opening a new market, or developing a new form of organization for the purpose of producing or enhancing a product.
2. *Running a business*. A *business*, as we saw in Chapter 1 "The Foundations of Business", combines resources to produce goods or services. Entrepreneurship means setting up a business to make a profit.
3. *Risk taking*. The term *risk* means that the outcome of the entrepreneurial venture can't be known. Entrepreneurs, therefore, are always working under a certain degree of *uncertainty*, and they can't know the outcomes of many of the decisions that they have to make. Consequently, many of the steps they take are motivated mainly by their confidence in the innovation and in their understanding of the business environment in which they're operating.

It isn't hard to recognize all three of these characteristics in the entrepreneurial experience of the Jurmains. They certainly had an *innovative* idea. But was it a *good* business idea? In a practical sense, a "good" business idea has to become something more than just an idea.

If, like the Jurmains, you're interested in generating income from your idea, you'll probably need to turn it into a *product*—something that you can market because it satisfies a need. If—again, like the Jurmains—you want to develop a product, you'll need some kind of organization to coordinate the resources necessary to make it a reality (in other words, a *business*). Risk enters the equation when, like the Jurmains, you make the decision to start up a business and when you commit yourself to managing it.

A Few Things to Know about Going into Business for Yourself



Figure 26 Mark Zuckerberg founded Facebook while a student at Harvard and, by age 27, has built up a personal wealth of \$13.5 billion

So what about you? Do you ever wonder what it would be like to start your own business? Maybe you want to try your hand at entrepreneurship. You could be the next Larry Page or Sergey Brin, cofounders of Google. Or the next David Marcks, a golf course manager who came up with the idea of Geese Police—training dogs to chase geese from golf courses, corporate parks, and municipal playgrounds.¹⁰⁵ Or even the next Pierre Omidyar, the French-born

software developer who built an online venue for person-to-person auctions, known as eBay.¹⁰⁶

You might even turn into a “serial entrepreneur” like Marcia Kilgore.¹⁰⁷ After high school, she moved from Canada to New York City to attend Columbia University. But when her financial aid was delayed, she abandoned her plans to attend college and took a job as a personal trainer (a natural occupation for a former bodybuilder and middleweight title holder). But things got boring in the summer when her wealthy clients left the city for the Hamptons. To keep busy, she took a skin care course at a Manhattan cosmetology institute. As a teenager, she was self-conscious about her bad complexion and wanted to know how to treat it herself. She learned how to give facials and work with natural remedies. Her complexion improved, and she started giving facials to her fitness clients who were thrilled with the results. As demand for her services exploded, she started her

first business—Bliss Spa—and picked up celebrity clients, including Madonna, Oprah Winfrey, and Jennifer Lopez. The business went international, and she sold it for more than \$30 million.¹⁰⁸

But the story doesn't end here; she didn't just sit back and enjoy her good fortune. Instead, she launched two more companies: Soap and Glory, a supplier of affordable beauty products sold at Target, and FitFlops, which sells sandals that tone and tighten your leg muscles as you walk. And by the way, remember how Oprah loved Kilgore's skin care products? She also loves Kilgore's sandals and plugged them on her talk show. You can't get a better endorsement than that. Kilgore never did finish college, but when asked if she would follow the same path again, she said, "If I had to decide what to do all over again, I would make the same choices...I found by accident what I'm good at, and I'm glad I did."

For the sake of argument, let's say that you would like to know a little more about going into business for yourself—in which case, you'll want some answers to questions like the following:

- Should I start a business?
- What are the advantages and disadvantages of starting a business?
- How do I come up with a business idea?
- Should I build a business from scratch, buy an existing business, or invest in a franchise?
- How do I go about planning a business?
- What steps are involved in developing a business plan?
- Where would I find help in getting my business started and operating it through the start-up phase?
- How can I increase the likelihood that I'll succeed?

In this chapter, we'll provide some answers to questions like these.

Why Start Your Own Business?

Let's say that you are interested in the idea of going into business for yourself. Not everyone, of course, has a desire to take the risks and put in the work involved in starting up a business. What sort of characteristics distinguishes those who do from those who

don't want to start a business? Or, more to the point, why do some people actually follow through on the desire to start up their own businesses? According to the Small Business Administration (SBA), a government agency that provides assistance to small businesses, the most common reasons for starting a business are the following:¹⁰⁹

- To be your own boss
- To accommodate a desired lifestyle
- To achieve financial independence
- To enjoy creative freedom
- To use your skills and knowledge

The Small Business Administration points out, though, that these are likely to be advantages only “for the right person.” And how do you know if you're one of the “right people”? The SBA suggests that you assess your strengths and weaknesses by asking yourself a few relevant questions:¹¹⁰

- *Am I a self-starter?* You'll need to develop and follow through on your ideas. You'll need to be able to organize your time.
- *How well do I get along with different personalities?* You'll need to develop working relationships with a variety of people, including unreliable vendors and sometimes cranky customers.
- *How good am I at making decisions?* You'll be making decisions constantly—often under pressure.
- *Do I have the physical and emotional stamina?* Can you handle six or seven workdays of as long as twelve hours every week?
- *How well do I plan and organize?* If you can't stay organized, you'll get swamped by the details. In fact, poor planning is the culprit in most business failures.
- *Is my drive strong enough?* You'll need to be highly motivated to withstand bad periods in your business, and simply being responsible for your business's success can cause you to burn out.
- *How will my business affect my family?* Family members need to know what to expect before you begin a business venture, such as financial difficulties and a more modest standard of living.

Later in this chapter, we'll take up the question of why businesses fail, but since we're still talking about the pros and cons of starting a business in the first place, we should consider one more issue: in addition to the number of businesses that start and then fail, a huge number of business ideas never even make it to the grand opening. One business analyst cites four reservations (or *fears*) that prevent people from starting businesses:¹¹¹

- *Money.* Granted, without the cash, you can't get very far. *What to do:* Conduct some research to find out where funding is available.
- *Security.* A lot of people don't want to sacrifice the steady income that comes with the nine-to-five job. *What to do:* Don't give up your day job. At least at first, think about hiring someone to run your business while you're gainfully employed elsewhere.
- *Competition.* A lot of people don't know how to distinguish their business ideas from similar ideas. *What to do:* Figure out how to do something cheaper, faster, or better.
- *Lack of ideas.* Some people simply don't know what sort of business they want to get into. *What to do:* Find out what trends are successful. Turn a hobby into a business. Think about a franchise.

If you're still interested in going into business for yourself, feel free to regard these potential drawbacks as mere obstacles to be overcome by a combination of planning and creative thinking.

Distinguishing Entrepreneurs from Small Business Owners

Though most entrepreneurial ventures begin as small businesses, not all small business owners are entrepreneurs. Entrepreneurs are innovators who start companies to create new or improved products. They strive to meet a need that's not being met, and their goal is to grow the business and eventually expand into other markets.

In contrast, many people either start or buy small businesses for the sole purpose of providing an income for themselves and their families. They do not intend to be particularly innovative, nor do they plan to expand significantly. This desire to operate is what's sometimes called a "lifestyle business."¹¹² The neighborhood pizza parlor or beauty shop, the self-employed consultant who works out of the home, and even a local printing

company—all of these are typical lifestyle businesses. In Section 5.2 "The Importance of Small Business to the U.S. Economy", we discuss the positive influences that both lifestyle and entrepreneurial businesses have on the U.S. economy.

Key Takeaways

- An **entrepreneur** is someone who identifies a business opportunity and assumes the risk of creating and running a business to take advantage of it.
- There are three characteristics of entrepreneurial activity:
 1. *Innovating*. An entrepreneur offers a new product, applies a new technique or technology, opens a new market, or develops a new form of organization for the purpose of producing or enhancing a product.
 2. *Running a business*. Entrepreneurship means setting up a business to make a profit from an innovative product or process.
 3. *Risk taking*. Risk means that an outcome is unknown. Entrepreneurs, therefore, are always working under a certain degree of uncertainty, and they can't know the outcomes of many of the decisions that they have to make.
- According to the SBA, a government agency that provides assistance to small businesses, there are five advantages to starting a business—"for the right person":
 1. Be your own boss.
 2. Accommodate a desired lifestyle.
 3. Achieve financial independence.

4. Enjoy creative freedom.
 5. Use your skills and knowledge.
- To determine whether you're one of the "right people" to exploit the advantages of starting your own business, the SBA suggests that you assess your strengths and weaknesses by asking yourself the following questions:
 1. Am I a self-starter?
 2. How well do I get along with different personalities?
 3. How good am I at making decisions?
 4. Do I have the physical and emotional stamina?
 5. How well do I plan and organize?
 6. Is my drive strong enough?
 7. How will my business affect my family?
 - Though most entrepreneurial ventures begin as small businesses, not all small business owners are entrepreneurs. Entrepreneurs are innovators who start companies to create new or improved products. In contrast, many people start businesses for the purpose of providing an income for themselves and their families. This type of businesses is sometimes called a "lifestyle business."

The Importance of Small Business to the U.S. Economy

Learning Objectives

1. Define a small business.
2. Explain the importance of small businesses to the U.S. economy.
3. Explain why small businesses tend to foster innovation more effectively than large ones.
4. Describe some of the ways in which small companies work with big ones.

What Is a "Small Business"?

To assess the value of small businesses to the U.S. economy, we first need to know what constitutes a small business. Let's start by looking at the criteria used by the Small

Business Administration. According to the SBA, a small business is one that is independently owned and operated, exerts little influence in its industry, and (with a few exceptions) has fewer than five hundred employees.¹¹³

Why Are Small Businesses Important?

Small business constitutes a major force in the U.S. economy. There are more than twenty-seven million small businesses in this country, and they generate about 50 percent of our gross domestic product (GDP).¹¹⁴ The millions of individuals who have started businesses in the United States have shaped the business world as we know it today. Some small business founders like Henry Ford and Thomas Edison have even gained places in history. Others, including Bill Gates (Microsoft), Sam Walton (Wal-Mart), Steve Jobs (Apple Computer), Michael Dell (Dell, Inc.), Steve Case (AOL), Pierre Omidyar (eBay), and Larry Page and Sergey Brin (Google), have changed the way business is done today. Still millions of others have collectively contributed to our standard of living.

Aside from contributions to our general economic well-being, founders of small businesses also contribute to growth and vitality in specific areas of economic and socioeconomic development. In particular, small businesses do the following:

- Create jobs
- Spark innovation
- Provide opportunities for many people, including women and minorities, to achieve financial success and independence

In addition, they complement the economic activity of large organizations by providing them with components, services, and distribution of their products. Let's take a closer look at each of these contributions.

Job Creation

The majority of U.S. workers first entered the business world working for small businesses. Today, half of all U.S. adults either are self-employed or work for businesses with fewer than five hundred employees.¹¹⁵ Although the split between those working in small companies and those working in big companies is about even, small firms hire more frequently and fire more frequently than do big companies.¹¹⁶ Why is this true? At any

given point in time, lots of small companies are started and some expand.

These small companies need workers and so hiring takes place. But the survival and expansion rates for small firms is poor, and so, again at any given point in time, many small businesses close or contract and workers lose their jobs. Fortunately, over time more jobs are added by small firms than are taken away, which results in a net increase in the number of workers. Table 1 "Small Firm Job Gains and Losses, 1993–2008 (in millions of jobs)" reports the net increase in jobs generated by small firms for the fifteen- year period of 1993 to 2008 and breaks it down into job gains from openings and expansions and job losses from closings and contractions.

Table 4 Small Firm Job Gains and Losses, 1993–2008 (in millions of jobs)

	Job Gains From		Job Losses From	
	Openings	Expansions	Closings	Contractions
Net Change	105.2	398.3	97.7	385.1

The size of the net increase in the number of workers for any given year depends on a number of factors, with the economy being at the top of the list. A strong economy encourages individuals to start small businesses and expand existing small companies, which adds to the workforce. A weak economy does just the opposite: discourages start-ups and expansions, which decreases the workforce through layoffs. Table 1 "Small Firm Job Gains and Losses, 1993–2008 (in millions of jobs)" reports the job gains from start-ups and expansions and job losses from business closings and contractions.

Innovation

Given the financial resources available to large businesses, you'd expect them to introduce virtually all the new products that hit the market. According to the SBA, small companies develop more patents per employee than do larger companies. During a recent four-year period, large firms generated 1.7 patents per hundred employees, whereas small firms generated an impressive 26.5 patents per employee.¹¹⁷ Over the years, the list of



important innovations by small firms has included the airplane and air-conditioning, the defibrillator and DNA fingerprinting, oral contraceptives and overnight national delivery, the safety razor, strobe lights, and the zipper.¹¹⁸

Small business owners are also particularly adept at finding new ways of doing old things. In 1994, for example, a young computer-science graduate working on Wall Street came up with the novel idea of selling books over the Internet. During the first year of operations, sales at Jeff Bezos's new company—Amazon.com—reached half a million dollars. In less than twenty years, annual sales had topped \$34 billion.¹¹⁹ Not only did his innovative approach to online retailing make Bezos enormously rich, but it also established a viable model for the e-commerce industry.

Why are small businesses so innovative? For one thing, they tend to offer environments that appeal to individuals with the talent to invent new products or improve the way things are done. Fast decision making is encouraged, their research programs tend to be focused, and their compensation structures typically reward top performers. According to one SBA study, the supportive environments of small firms are roughly thirteen times more innovative per employee than the less innovation-friendly environments in which large firms traditionally operate.¹²⁰

The success of small businesses in fostering creativity has not gone unnoticed by big businesses. In fact, many large companies have responded by downsizing to act more like small companies. Some large organizations now have separate work units whose purpose is to spark innovation. Individuals working in these units can focus their attention on creating new products that can then be developed by the company.

Opportunities for Women and Minorities

Small business is the portal through which many people enter the economic mainstream. Business ownership allows individuals, including women and minorities, to achieve financial success, as well as pride in their accomplishments. While the majority of small businesses are still owned by white males, the past two decades have seen a substantial

increase in the number of businesses owned by women and minorities. Figure 2 "Businesses Owned by Women and Minorities"¹²¹ gives you an idea of how many American businesses are owned by women and minorities, and indicates how much the

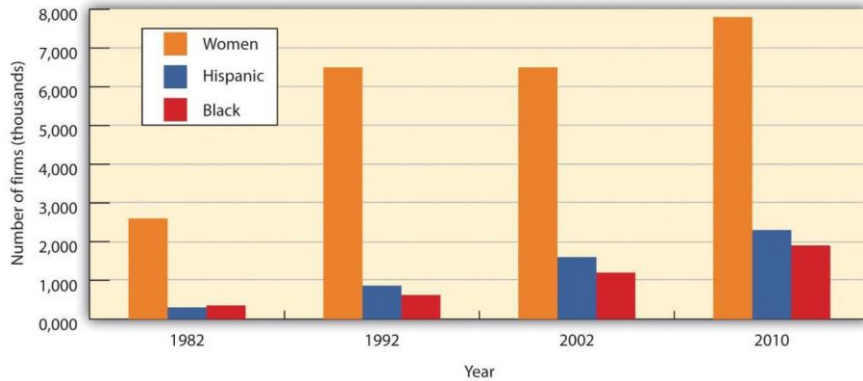


Figure 27 Businesses Owned by Women and Minorities

numbers grew between 1982 and 2007.¹²²

What Small Businesses Do for Big Businesses

Small firms complement large firms in a number of ways. They supply many of the components

needed by big companies. For example, the U.S. automakers depend on more than 1,700 suppliers to provide them with the parts needed to make their cars. While many of the suppliers are large, there are hundreds of smaller companies that provide a substantial portion of the 8,000 to 12,000 parts that go into each vehicle.¹²³ Small firms also provide large ones with such services as accounting, legal, and insurance. Many small firms provide *outsourcing* services to large firms—that is, they hire themselves out to help with special projects or handle certain business functions. A large firm, for example, might hire a small one to handle its billing or collection services or to manage its health care benefits. A large company might contract with a small information technology firm to manage its Web site or oversee software upgrades.

Small companies provide another valuable service to large companies by acting as sales agents for their products. For example, automobile dealerships, which are generally small businesses, sell vehicles for the big car makers. Local sporting goods stores sell athletic shoes made by industry giants, such as Adidas and Nike. Your corner deli sells products made by large companies, such as Coca-Cola and Frito-Lay.

Key Takeaways

- According to the SBA, a **small business** is independently owned and operated, exerts little influence in its industry, and (with minimal exceptions) has fewer than five hundred employees.
- The nearly twenty-seven million small businesses in the United States generate about 50 percent of our GDP. They also contribute to growth and vitality in several important areas of economic and socioeconomic development. In particular, small businesses do the following:
 1. Create jobs
 2. Spark innovation
 3. Provide opportunities for women and minorities to achieve financial success and independence
- Small businesses tend to foster environments that appeal to individuals with the talent to invent new products or improve the way things are done. They typically make faster decisions, their research programs often are focused, and their compensation structures frequently reward top performers.
- Small firms supply many of the components needed by big companies. They also provide large firms with such services as accounting, legal, and insurance, and many provide *outsourcing* services to large companies—that is, they hire themselves out to help with special projects or handle certain business functions. Small companies (such as automotive dealerships) often act as sales agents for the products of large businesses (for example, car makers).

Advantages and Disadvantages of Business Ownership

Learning Outcomes

1. Summarize the advantages and disadvantages of business ownership.

Do you want to be a business owner someday? Before deciding, you might want to consider the following advantages and disadvantages of business ownership.¹²⁴

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Advantages of Small Business Ownership

Being a business owner can be extremely rewarding. Having the courage to take a risk and start a venture is part of the American dream. Success brings with it many advantages:

- *Independence.* As a business owner, you're your own boss. You can't get fired. More importantly, you have the freedom to make the decisions that are crucial to your own business success.
- *Lifestyle.* Owning a small business gives you certain lifestyle advantages. Because you're in charge, you decide when and where you want to work. If you want to spend more time on non-work activities or with your family, you don't have to ask for the time off. If it's important that you be with your family all day, you might decide to run your business from your home. Given today's technology, it's relatively easy to do. Moreover, it eliminates commuting time.
- *Financial rewards.* In spite of high financial risk, running your own business gives you a chance to make more money than if you were employed by someone else. You benefit from your own hard work.
- *Learning opportunities.* As a business owner, you'll be involved in all aspects of your business. This situation creates numerous opportunities to gain a thorough understanding of the various business functions.
- *Creative freedom and personal satisfaction.* As a business owner, you'll be able to work in a field that you really enjoy. You'll be able to put your skills and knowledge to use, and you'll gain personal satisfaction from implementing your ideas, working directly with customers, and watching your business succeed.

Disadvantages of Small Business Ownership

As the little boy said when he got off his first roller-coaster ride, "I like the ups but not the downs!" Here are some of the risks you run if you want to start a small business:

- *Financial risk.* The financial resources needed to start and grow a business can be extensive. You may need to commit most of your savings or even go into debt to get

started. If things don't go well, you may face substantial financial loss. In addition, there's no guaranteed income. There might be times, especially in the first few years, when the business isn't generating enough cash for you to live on.

- *Stress.* As a business owner, you *are* the business. There's a bewildering array of things to worry about—competition, employees, bills, equipment breakdowns, customer problems. As the owner, you're also responsible for the well-being of your employees.
- *Time commitment.* People often start businesses so that they'll have more time to spend with their families. Unfortunately, running a business is extremely time-consuming. In theory, you have the freedom to take time off, but in reality, you may not be able to get away. In fact, you'll probably have less free time than you'd have working for someone else. For many entrepreneurs and small business owners, a forty-hour workweek is a myth; see Figure 5.6 "The Entrepreneur's Workweek". Vacations will be difficult to take and will often be interrupted. In recent years, the difficulty of getting away from the job has been compounded by cell phones, iPhones, Internet-connected laptops and iPads, and many small business owners have come to regret that they're always reachable.
- *Undesirable duties.* When you start up, you'll undoubtedly be responsible for either doing or overseeing just about everything that needs to be done. You can get bogged down in detail work that you don't enjoy. As a business owner, you'll probably have to perform some unpleasant tasks, like firing people.

In spite of these and other disadvantages, most small business owners are pleased with their decision to start a business. A survey conducted by the *Wall Street Journal* and Cicco and Associates indicates that small business owners and top-level corporate executives agree overwhelmingly that small business owners have a more satisfying business experience. Interestingly, the researchers had fully expected to find that small business owners were happy with their choices; they were, however, surprised at the number of corporate executives who believed that the grass was greener in the world of small business ownership.¹²⁵

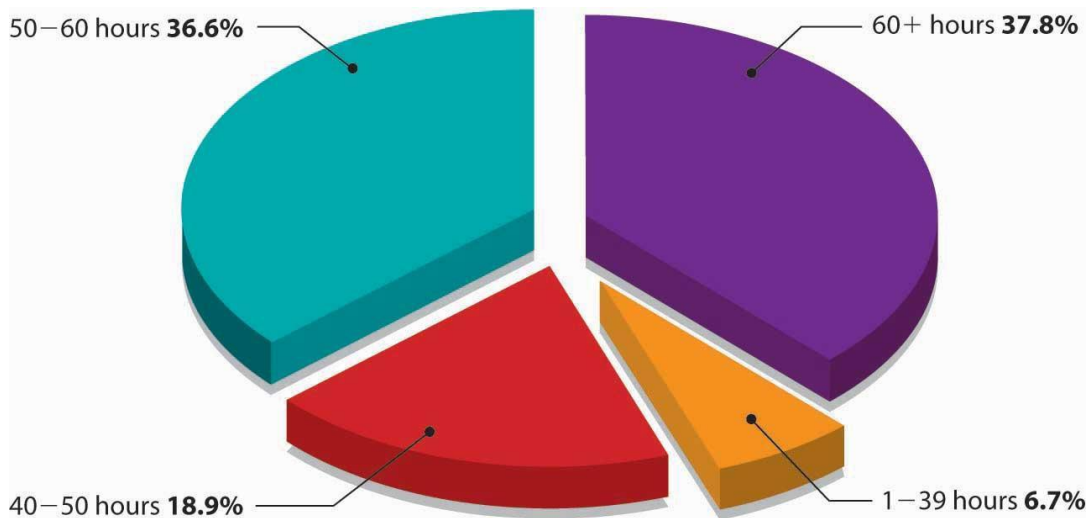


Figure 28 The Entrepreneur's Workweek

Key Takeaways

- There are several advantages that, generally speaking, come with success in business ownership:
 1. *Independence.* As a business owner, you're your own boss.
 2. *Lifestyle.* Because you're in charge, you decide when and where you want to work.
 3. *Financial rewards.* In spite of high financial risk, running your own business gives you a chance to make more money than if you were employed by someone else.
 4. *Learning opportunities.* As a business owner, you'll be involved in all aspects of your business.
 5. *Creative freedom and personal satisfaction.* As a business owner, you'll be able to work in a field that you really enjoy, and you'll gain personal satisfaction from watching your business succeed.

- There are also a number of potential disadvantages to consider in deciding whether to start a small business:
 1. *Financial risk.* The financial resources needed to start and grow a business can be extensive, and if things don't go well, you may face substantial financial loss. In addition, you'll have no guaranteed income.
 2. *Stress.* You'll have a bewildering array of things to worry about—competition, employees, bills, equipment breakdowns, customer problems.
 3. *Time commitment.* Running a business is extremely time-consuming. In fact, you'll probably have less free time than you'd have working for someone else.
 4. *Undesirable duties.* You'll be responsible for either doing or overseeing just about everything that needs to be done, and you'll probably have to perform some unpleasant tasks, like firing people.

Starting a Business

Learning Outcomes

1. Explain what it takes to start a business.
2. Evaluate the advantages and disadvantages of several small business ownership options—starting a business from scratch, buying an existing business, and obtaining a franchise.

Starting a business takes talent, determination, hard work, and persistence. It also requires a lot of research and planning. Before starting your business, you should appraise your strengths and weaknesses and assess your personal goals to determine whether business ownership is for you.¹²⁶

Questions to Ask Before You Start a Business

If you're interested in starting a business, you need to make decisions even before you bring your talent, determination, hard work, and persistence to bear on your project.

Here are the basic questions you'll need to address:

- What, exactly, is my business idea? Is it feasible?

- What type of business is right for me? What industry do I want to get into? Do I want to be a manufacturer, a retailer, or a wholesaler? Do I want to provide professional or personal services? Do I want to start a business that I can operate out of my home?
- Do I want to run a business that's similar to many existing businesses? Do I want to innovate—to create a new product or a new approach to doing business?
- Do I want to start a new business, buy an existing one, or buy a franchise?
- Do I want to start the business by myself or with others?
- What form of business organization do I want?

After making these decisions, you'll be ready to take the most important step in the entire process of starting a business: you must describe your future business in the form of a business plan—a document that identifies the goals of your proposed business and explains how these goals will be achieved. Think of a business plan as a blueprint for a proposed company: it shows how you intend to build the company and how you intend to make sure that it's sturdy. You must also take a second crucial step before you actually start up your business: You need to get financing—the money from individuals, banks, or both, that you'll need to get your business off the ground. (Obviously, if you already have the necessary funds, you're one of the fortunate few who can skip this step.)

The Business Idea

For some people, coming up with a great business idea is a gratifying adventure. For most, however, it's a daunting task. The key to coming up with a business idea is identifying something that customers want—or, perhaps more importantly, filling an unmet need. Your business will probably survive only if its purpose is to *satisfy its customers*—the ultimate users of its goods or services. In coming up with a business idea, don't ask, "What do we want to sell?" but rather, "What does the customer want to buy?"¹²⁷

To come up with an innovative business idea, you need to be creative. The idea itself can come from various sources. Prior experience accounts for the bulk of new business ideas. Many people generate ideas for industries they're already working in. Past experience in an industry also increases your chances of success. Take Sam Walton, the late founder of Wal-Mart. He began his retailing career at JCPenney and then became a successful

franchiser of a Ben Franklin five-and-dime store. In 1962, he came up with the idea of opening large stores in rural areas, with low costs and heavy discounts. He founded his first Wal-Mart store in 1962, and when he died thirty years later, his family's net worth was \$25 billion.¹²⁸

Industry experience also gave Howard Schultz, a New York executive for a housewares company, his breakthrough idea. In 1981, Schultz noticed that a small customer in Seattle—Starbucks Coffee, Tea and Spice—ordered more coffeemaker cone filters than Macy's and many other large customers. So he flew across the country to find out why. His meeting with the owner-operators of the original Starbucks Coffee Co. resulted in his becoming part-owner of the company, and changed his life and the life of coffee lovers forever. Schultz's vision for the company far surpassed that of its other owners.

While they wanted Starbucks to remain small and local, Schultz saw potential for a national business that not only sold world-class-quality coffee beans but also offered customers a European coffee-bar experience. After attempting unsuccessfully to convince his partners to try his experiment, Schultz left Starbucks and started his own chain of coffee bars, which he called Il Giornale (after an Italian newspaper). Two years later, he bought out the original owners and reclaimed the name Starbucks.¹²⁹

Other people come up with business ideas because of hobbies or personal interests. This was the case with Nike founder Phil Knight, who was an avid runner. He was convinced that it was possible to make high-quality track shoes that cost less than the European shoes dominating the market at the time. His track experience, coupled with his knowledge of business (Knight holds an MBA from Stanford and worked as an accountant), inspired him to start Nike. Michael Dell also turned a personal interest into a business. From a young age, he was obsessed with taking computers apart and putting them back together again, and it was this personal interest that led to his great business idea. At college, instead of attending classes, he spent his time assembling computers and, eventually, founded Dell, Inc. We will expand on this important topic of idea generation and creativity in other chapters.

Ownership Options

As we've already seen, you can become a small business owner in one of three ways— by

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starting a new business, buying an existing one, or obtaining a franchise. Let's look more closely at the advantages and disadvantages of each option.

Starting from Scratch

The most common—and the riskiest—option is starting from scratch. This approach lets you start with a clean slate and allows you to build the business the way you want. You select the goods or services that you're going to offer, secure your location, and hire your employees, and then it's up to you to develop your customer base and build your reputation. This is the path taken by Andres Mason who figured out how to inject hysteria into the process of bargain hunting on the Web. The result is an overnight success story called Groupon.¹³⁰ Here is how Groupon (a blend of the words “group” and “coupon”) works: A daily email is sent to 6.5 million people in 70 cities across the United States offering a deeply discounted deal to buy something or to do something in their city. If the person receiving the email likes the deal, he or she commits to buying it. But, here's the catch, if not enough people sign up for the deal, it is cancelled. Groupon makes money by keeping half of the revenue from the deal. The company offering the product or service gets exposure. But stay tuned: the “daily deals website isn't just unprofitable—it's bleeding hundreds of millions of dollars.”¹³¹ As with all start-ups cash is always a problem.

Buying an Existing Business

If you decide to buy an existing business, some things will be easier. You'll already have a proven product, current customers, active suppliers, a known location, and trained employees. You'll also find it much easier to predict the business's future success. There are, of course, a few bumps in this road to business ownership. First, it's hard to determine how much you should pay for a business. You can easily determine how much things like buildings and equipment are worth, but how much should you pay for the fact that the business already has steady customers?

In addition, a business, like a used car, might have performance problems that you can't detect without a test drive (an option, unfortunately, that you don't get when you're buying a business). Perhaps the current owners have disappointed customers; maybe the location isn't as good as it used to be. You might inherit employees that you wouldn't have hired yourself. Finally, what if the previous owners set up a competing business that draws

away their former—and your current—customers?

Getting a Franchise

Lastly, you can buy a franchise. Under this setup, a *franchiser* (the company that sells the franchise) grants the *franchisee* (the buyer—you) the right to use a brand name and to sell its goods or services. Franchises market products in a variety of industries, including food, retail, hotels, travel, real estate, business services, cleaning services, and even weight-loss centers and wedding services. There are thousands of franchises, many of which are quite familiar—SUBWAY, McDonald's, 7-Eleven, Holiday Inn, Budget Car Rental, RadioShack, and Jiffy Lube.

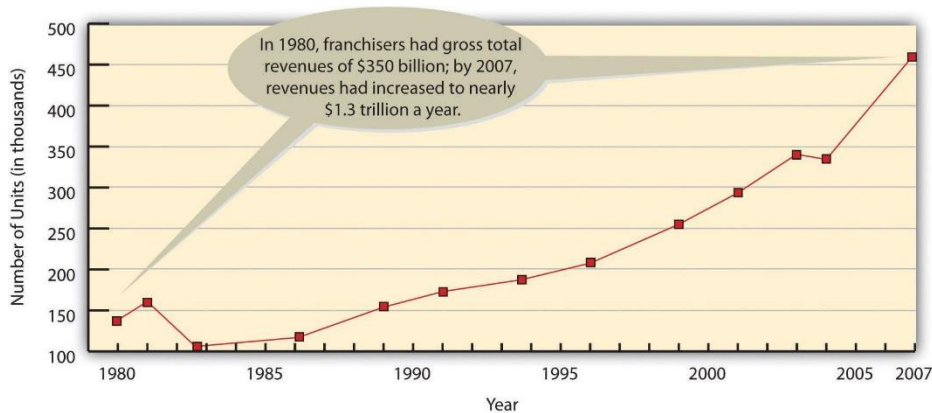


Figure 29 The Growth of Franchising, 1980–2007

As you can see from Figure 4 "The Growth of Franchising, 1980–2007", franchising has become an extremely popular way to do business. A new franchise outlet opens once every eight

minutes in the United States, where one in ten businesses is now a franchise. Franchises employ eight million people (13 percent of the workforce) and account for 17 percent of all sales in this country (\$1.3 trillion).¹³²

In addition to the right to use a company's brand name and sell its products, the franchisee gets help in picking a location, starting and operating the business, and advertising. In effect, you've bought a prepackaged, ready-to-go business that's proven successful elsewhere. You also get ongoing support from the franchiser, which has a vested interest in your success.

Not surprisingly, these advantages don't come cheaply. Franchises can be very expensive, usually depending on the amount of business that a franchisee is expected to do. KFC franchises, for example, require a total investment of \$1.3 million to \$2.5 million each. This fee includes the cost of the property, equipment, training, start-up costs, and

the *franchise fee*—a one-time charge for the right to operate as a KFC outlet. McDonald's is in the same price range (\$1.1 million to \$1.9 million). SUBWAY sandwich shops are more affordable, with expected total investment ranging from \$84,000 to \$258,000. If you'd prefer teaching dance and exercise classes, you could get a Jazzercise franchise for anywhere from \$3,000 to \$76,000. If you don't want to deal in food or dance, you might want to buy a dating service. The Right One® franchises go for an initial investment of \$98,000 to \$254,000, depending on location.¹³³

In addition to your initial investment, you'll have to pay two other fees on a monthly basis—a *royalty fee* (typically from 3 to 12 percent of sales) for continued support from the franchiser and the right to keep using the company's trade name, plus an *advertising fee* to cover your share of national and regional advertising. You'll also be expected to buy your products from the franchiser.¹³⁴

Why do would-be business owners like franchises? For one thing, buying a franchise lets you start up under fairly safe conditions, with a proven model for running a company and a permanent support team. You can profit from name recognition without having to develop your own image in the marketplace, and you can be your own boss (as long as you comply with the standards set by the franchiser).

But there are disadvantages. The cost of obtaining and running a franchise can be high, and you have to play by the franchiser's rules, even when you disagree with them. The franchiser maintains a great deal of control over its franchisees. For example, if you own a fast-food franchise, the franchise agreement will likely dictate the food and beverages you can sell; the methods used to store, prepare, and serve the food; and the prices you'll charge. In addition, the agreement will dictate what the premises will look like and how they'll be maintained.

Finally, franchisers don't always keep their promises. What do you do if the promised advertising or employee training doesn't materialize? What do you do if you're forced to make unnecessary and costly alterations to your premises, or the franchising company sets up a competing establishment nearby? What if the franchising company gets bad press, which, in turn, hurts your sales? You always have the option of suing the franchiser, but this is time-consuming and costly. As with any business venture, you need to do your

homework before investing in a franchise.

Key Takeaways

- Before starting a business, you need to ask yourself a few basic questions:
 1. What, exactly, is my *business idea*? Is it feasible?
 2. What type of business is right for me? What *industry* do I want to get into?
 3. Do I want to run a business that's similar to many existing businesses, or do I want to innovate?
 4. Do I want to start a new business, take over an existing one, or buy a franchise?
 5. Do I want to start the business by myself, or do I want company?
 6. What form of *business organization* do I want?
- After you've addressed these basic questions, you'll be ready to describe your future business in the form of a **business plan**—a document that identifies the goals of your proposed business and explains how it will achieve them. Before you actually start up your business, you must also get financing.
- The key to coming up with a business idea is identifying something that customers want. Your business will probably survive only if its “purpose” is to *satisfy its customers*—the ultimate users of its goods or services.

- You can become a small business owner in one of three ways, each of which has advantages and disadvantages:
 1. *Starting from scratch.* This is the most common—and riskiest—option. *Advantage:* You start with a clean slate and build the business the way you want. *Disadvantage:* It's up to you to develop your customer base and build your reputation.
 2. *Buying an existing business.* This option is not as risky as starting a business from scratch, but it has some drawbacks. *Advantages:* You'll already have a proven product, current customers, active suppliers, a known location, and trained employees. *Disadvantages:* It's hard to determine how much to pay for a business; perhaps the current owners have disappointed customers; maybe the location isn't as good as it used to be.
 3. *Buying a franchise.* Under a **franchise** setup, a *franchiser* (the company that sells the franchise) grants the *franchisee* (the buyer) the right to use a brand name and to sell its goods or services. *Advantages:* You've bought a prepackaged, ready-to-go business that's proven successful elsewhere; you also get ongoing support from the franchiser. *Disadvantages:* The cost can be high; you have to play by the franchiser's rules; and franchisers don't always keep their promises.

The Business Plan

Learning Outcomes

1. Discuss the importance of planning for your business, and identify the key sections of a business plan.

If you want to start a business, you must prepare a business plan. This essential document should tell the story of your business concept, provide an overview of the industry in which you will operate, describe the goods or services you will provide, identify your customers and proposed marketing activities, explain the qualifications of your management team, and state your projected income and borrowing needs.

Purpose of a Business Plan

The business plan is a plan or blueprint for the company, and it's an indispensable tool in attracting investors, obtaining loans, or both. Remember, too, that the value of your business plan isn't limited to the planning stages of your business and the process of finding start-up money. Once you've acquired start-up capital, don't just stuff your plan in a drawer. Treat it as an ongoing guide to your business and its operations, as well as a yardstick by which you can measure your performance. Keep it handy, update it periodically, and use it to assess your progress.

In developing and writing your business plan, you must make strategic decisions in the areas of management, operations, marketing, accounting, and finance—in short, in all the functional areas of business that we described in Chapter 1 "The Foundations of Business". Granted, preparing a business plan takes a lot of time and work, but it's well worth the effort. A business plan forces you to think critically about your proposed business and reduces your risk of failure. It forces you to analyze your business concept and the industry in which you'll be operating, and it helps you determine how you can grab a percentage of sales in that industry.

The most common use of a business plan is persuading investors, lenders, or both, to provide financing. These two groups look for different things. Investors are particularly interested in the quality of your business concept and the ability of management to make your venture successful. Bankers and other lenders are primarily concerned with your company's ability to generate cash to repay loans. To persuade investors and lenders to support your business, you need a professional, well-written business plan that paints a clear picture of your proposed business.

Sections of the Business Plan

Though formats can vary, a business plan generally includes the following sections: executive summary, description of proposed business, industry analysis, mission statement and core values, management plan, goods or services and (if applicable) production processes, marketing, global issues, and financial plan. Let's explore each of these sections in more detail. (*Note:* More detailed documents and an Excel template are available for those classes in which the optional business plan project is assigned.)

Executive Summary

The executive summary is a one- to three-page overview of the business plan. It's actually the most important part of the business plan: it's what the reader looks at first, and if it doesn't capture the reader's attention, it might be the only thing that he or she looks at. It should therefore emphasize the key points of the plan and get the reader excited about the prospects of the business.

Even though the executive summary is the first thing read, it's written *after* the other sections of the plan are completed. An effective approach in writing the executive summary is to paraphrase key sentences from each section of the business plan. This process will ensure that the key information of each section is included in the executive summary.

Description of Proposed Business

Here, you present a *brief* description of the company and tell the reader why you're starting your business, what benefits it provides, and why it will be successful. Some of the questions to answer in this section include the following:

- What will your proposed company do? Will it be a manufacturer, a retailer, or a service provider?
- What goods or services will it provide?
- Why are your goods or services unique?
- Who will be your main customers?
- How will your goods or services be sold?
- Where will your business be located?

Because later parts of the plan will provide more detailed discussions of many of these issues, this section should provide only an overview of these topics.

Industry Analysis

This section provides a brief introduction to the industry in which you propose to operate. It describes both the current situation and the future possibilities, and it addresses such questions as the following:

- How large is the industry? What are total sales for the industry, in volume and

dollars?

- Is the industry mature or are new companies successfully entering it?
- What opportunities exist in the industry? What threats exist?
- What factors will influence future expansion or contraction of the industry?
- What is the overall outlook for the industry?
- Who are your major competitors in the industry?
- How does your product differ from those of your competitors?

Mission Statement and Core Values

This portion of the business plan states the company's *mission statement* and *core values*.

The mission statement describes the purpose or *mission* of your organization—its reason for existence. It tells the reader what the organization is committed to doing. For example, one mission statement reads, “The mission of Southwest Airlines is dedication to the highest quality of customer service delivered with a sense of warmth, friendliness, individual pride, and company spirit.”¹³⁵

Core values are fundamental beliefs about what's important and what is (and isn't) appropriate in conducting company activities. Core values are not about profits, but rather about ideals. They should help guide the behavior of individuals in the organization. Coca-Cola, for example, intends that its core values—leadership, passion, integrity, collaboration, diversity, quality, and accountability—will let employees know what behaviors are (and aren't) acceptable.¹³⁶

Management Plan

Management makes the key decisions for the business, such as its legal form and organizational structure. This section of the business plan should outline these decisions and provide information about the qualifications of the key management personnel.

1. Legal Form of Organization

This section identifies the chosen legal form of business ownership: sole proprietorship (personal ownership), partnership (ownership shared with one or more partners), or corporation (ownership through shares of stock).

2. Qualifications of Management Team and Compensation

Package

It isn't enough merely to have a good business idea: you need a talented management team that can turn your concept into a profitable venture. This part of the management plan section provides information about the qualifications of each member of the management team. Its purpose is to convince the reader that the company will be run by experienced, well-qualified managers. It describes each individual's education, experience, and expertise, as well as each person's responsibilities. It also indicates the estimated annual salary to be paid to each member of the management team.

3. Organizational Structure

This section of the management plan describes the relationships among individuals within the company, listing the major responsibilities of each member of the management team.

Goods, Services, and the Production Process

To succeed in attracting investors and lenders, you must be able to describe your goods or services clearly (and enthusiastically). Here, you describe all the goods and services that you will provide the marketplace. This section explains why your proposed offerings are better than those of competitors and indicates what market needs will be met by your goods or services. In other words, it addresses a key question: *What competitive advantage* will the company's goods and services have over similar products on the market?

This section also indicates how you plan to obtain or make your products. Naturally, the write-up will vary, depending on whether you're proposing a service company, a retailer, or a manufacturer. If it's a service company, describe the process by which you'll deliver your services. If it's a retail company, tell the reader where you'll purchase products for resale.

If you're going to be a manufacturer, you must furnish information on product design, development, and production processes. You must address questions such as the following:

- How will products be designed?

- What technology will be needed to design and manufacture products?
- Will the company run its own production facilities, or will its products be manufactured by someone else?
- Where will production facilities be located?
- What type of equipment will be used?
- What are the design and layout of the facilities?
- How many workers will be employed in the production process?
- How many units will be produced?
- How will the company ensure that products are of high quality?

Marketing

This critical section focuses on four marketing-related areas—target market, pricing, distribution, and promotion:

1. *Target market.* Describe future customers and profile them according to age, gender, income, interests, and so forth. If your company will sell to other companies, describe your typical business customer.
2. *Pricing.* State the proposed price for each product. Compare your pricing strategy to that of competitors.
3. *Distribution.* Explain how your goods or services will be distributed to customers. Indicate whether they'll be sold directly to customers or through retail outlets.
4. *Promotion.* Explain your promotion strategy, indicating what types of advertising you'll be using.

In addition, if you intend to use the Internet to promote or sell your products, also provide answers to these questions:

- Will your company have a Web site? Who will visit the site?
- What will the site look like? What information will it supply?
- Will you sell products over the Internet?
- How will you attract customers to your site and entice them to buy from your company?

Global Issues

In this section, indicate whether you'll be involved in international markets, by either buying or selling in other countries. If you're going to operate across borders, identify the challenges that you'll face in your global environment, and explain how you'll meet them. If you don't plan initially to be involved in international markets, state what strategies, if any, you'll use to move into international markets when the time comes.

Financial Plan

In preparing the financial section of your business plan, specify the company's cash needs and explain how you'll be able to repay debt. This information is vital in obtaining financing. It reports the amount of cash needed by the company for start-up and initial operations and provides an overview of proposed funding sources. It presents financial projections, including expected sales, costs, and profits (or losses). It refers to a set of financial statements included in an appendix to the business plan.

Appendices

Here, you furnish supplemental information that may be of interest to the reader. In addition to a set of financial statements, for example, you might attach the résumés of your management team.

Key Takeaways

- A **business plan** tells the story of your business concept, provides an overview of the industry in which you will operate, describes the goods or services you will provide, identifies your customers and proposed marketing activities, explains the qualifications of your management team, and states your projected income and borrowing needs.
- In your business plan, you make strategic decisions in the areas of management, operations, marketing, accounting, and finance. Developing your business plan forces you to analyze your business concept and the industry in which you'll be operating. Its most common use is persuading investors and lenders to provide financing.
- A business plan generally includes the following sections:
 1. **Executive summary.** One- to three-page overview.
 2. **Description of proposed business.** Brief description of the company that answers such questions as what your proposed company will do, what goods or services it will provide, and who its main customers will be.
 3. **Industry analysis.** Short introduction to the industry in which you propose to operate.
 4. **Mission statement and core values.** Declaration of your **mission statement**, which are fundamental beliefs about what's important and what is (and isn't) appropriate in conducting company activities.
 5. **Management plan.** Information about management team qualifications and responsibilities, and designation of your proposed legal form of organization.
 6. **Goods, services, and the production process.** Description of the goods and services that you'll provide in the marketplace; explanation of how you plan to obtain or make your products or of the process by which you'll deliver your services.

7. **Marketing.** Description of your plans in four marketing-related areas: target market, pricing, distribution, and promotion.
8. **Global issues.** Description of your involvement, if any, in international markets.
9. **Financial plan.** Report on the cash you'll need for start-up and initial operations, proposed funding sources, and means of repaying your debt.
10. **Appendices.** Supplemental information that may be of interest to the reader.

How to Succeed in Managing a Business

Learning Outcomes

1. Discuss ways to succeed in managing a business, and explain why some businesses fail.
2. Identify sources of small business assistance from the Small Business Administration.

Why Do Businesses Succeed?

Being successful as a business owner requires more than coming up with a brilliant idea and working hard. You need to learn how to manage and grow your business. In the process, you'll face numerous challenges, and your ability to meet them will be a major factor in your success (or failure).¹³⁷ To give yourself a fighting chance in making a success of your business, you should do the following:

- *Know your business.* It seems obvious, but it's worth mentioning: successful businesspeople know what they're doing. They're knowledgeable about the industry in which they operate (both as it stands today and where it's headed), and they know who their competitors are. They know how to attract customers and who the best suppliers and distributors are, and they understand the impact of technology on their business.
- *Know the basics of business management.* You might be able to *start* a business on

the basis of a great idea, but to *manage* it you need to understand the functional areas of business—accounting, finance, management, marketing, and production. You need to be a salesperson, as well as a decision maker and a planner.

- *Have the proper attitude.* When you own a business, you *are* the business. If you're going to devote the time and energy needed to transform an idea into a successful venture, you need to have a passion for your work. You should believe in what you're doing and make a strong personal commitment to your business.
- *Get adequate funding.* It takes a lot of money to start a business and guide it through the start-up phase (which can last for over a year). You can have the most brilliant idea in the world, the best marketing approach, and a talented management team, yet if you run out of cash, your career as a business owner could be brief. Plan for the long term and work with lenders and investors to ensure that you'll have sufficient funds to get open, stay open during the start-up phase, and, ultimately, expand.
- *Manage your money effectively.* You'll be under constant pressure to come up with the money to meet payroll and pay your other bills. That's why you need to keep an eye on *cash flow*—money coming in and money going out. You need to control costs and collect money that's owed you, and, generally, you need to know how to gather the financial information that you require to run your business.
- *Manage your time efficiently.* A new business owner can expect to work sixty hours a week. If you want to grow a business and have some type of non-work life at the same time, you'll have to give up some control—to let others take over some of the work. Thus, you must develop time-management skills and learn how to delegate responsibility.
- *Know how to manage people.* Hiring, keeping, and managing good people are crucial to business success. As your business grows, you'll depend more on your employees. You need to develop a positive working relationship with them, train them properly, and motivate them to provide quality goods or services.

- *Satisfy your customers.* You might attract customers through impressive advertising campaigns, but you'll keep them only by providing quality goods or services. Commit yourself to satisfying—or even exceeding—customer needs.
- *Know how to compete.* Find your niche in the marketplace, keep an eye on your competitors, and be prepared to react to changes in the marketplace. The history of business (and much of life) can be summed up in three words: “Adapt or perish.”

Why Do Businesses Fail?

If you've paid attention to the occupancy of shopping malls over a few years, you've noticed that retailers come and go with surprising frequency. The same thing happens with restaurants—indeed, with all kinds of businesses. By definition, starting a business—small or large—is risky, and though many businesses succeed, a large proportion of them don't. One-third of small businesses that have employees go out of business within the first two years. More than half of small businesses have closed by the end of their fourth year, and 70 percent do not make it past their seventh year.¹³⁸

Table 5 Survival Rate of New Companies

Number of Years after Start-up	Rate of Survival
1	81.2%
2	65.8%
3	54.3%
4	44.4%
5	38.3%
6	34.4%
7	31.2%
Note: Percentages based on a total of 212,182 businesses that started up in the second quarter of 1998.	

As bad as these statistics on business survival are, some industries are worse than others. If you want to stay in business for a long time, you might want to avoid some of these risky industries. Even though your friends think you make the best macaroni and cheese pizza in the world, this doesn't mean you can succeed as a pizza parlor owner. Opening a

restaurant or a bar is one of the riskiest ventures (and, therefore, start-up funding is hard to get). You might also want to avoid the transportation industry. Owning a taxi might appear lucrative until you find out what a taxi license costs. It obviously varies by city, but in New York City the price tag is upward of \$400,000. And setting up a shop to sell clothing can be challenging. Your view of “what’s in” may be off, and one bad season can kill your business. The same is true for stores selling communication devices: every mall has one or more cell phone stores so the competition is steep, and business can be very slow.¹³⁹

Businesses fail for any number of reasons, but many experts agree that the vast majority of failures result from some combination of the following problems:

- *Bad business idea.* Like any idea, a business idea can be flawed, either in the conception or in the execution. If you tried selling snow blowers in Hawaii, you could count on little competition, but you’d still be doomed to failure.
- *Cash problems.* Too many new businesses are underfunded. The owner borrows enough money to set up the business but doesn’t have enough extra cash to operate during the start-up phase, when very little money is coming in but a lot is going out.
- *Managerial inexperience or incompetence.* Many new business owners have no experience in running a business; many have limited management skills. Maybe an owner knows how to make or market a product but doesn’t know how to manage people. Maybe an owner can’t attract and keep talented employees. Maybe an owner has poor leadership skills and isn’t willing to plan ahead.
- *Lack of customer focus.* A major advantage of a small business is the ability to provide special attention to customers. But some small businesses fail to seize this advantage. Perhaps the owner doesn’t anticipate customers’ needs or keep up with changing markets or the customer-focused practices of competitors.
- *Inability to handle growth.* You’d think that a sales increase would be a good thing. Often it is, of course, but sometimes it can be a major problem. When a company grows, the owner’s role changes. He or she needs to delegate work to others and

build a business structure that can handle the increase in volume. Some owners don't make the transition and find themselves overwhelmed. Things don't get done, customers become unhappy, and expansion actually damages the company.

Help from the SBA

If you had your choice, which cupcake would you pick—vanilla Oreo, triple chocolate, or latte? In the last few years, cupcake shops are popping up in almost every city. Perhaps the bad economy has put people in the mood for small, relatively inexpensive treats. Whatever the reason, you're fascinated with the idea of starting a cupcake shop. You have a perfect location, have decided what equipment you need, and have tested dozens of recipes (and eaten lots of cupcakes). You are set to go with one giant exception: you don't have enough savings to cover your start-up costs. You have made the round of most local banks, but they are all unwilling to give you a loan. So what do you do? Fortunately, there is help available. It is through your local Small Business Administration (SBA), which offers an array of programs to help current and prospective small business owners. The SBA won't actually loan you the money, but it will increase the likelihood that you will get funding from a local bank by guaranteeing the loan.

Here's how the SBA's loan guaranty program works: You apply to a bank for financing. A loan officer decides if the bank will loan you the money without an SBA guarantee. If the answer is no (because of some weakness in your application), the bank then decides if it will loan you the money if the SBA guarantees the loan. If the bank decides to do this, you get the money and make payments on the loan. If you default on the loan, the government reimburses the bank for its loss, up to the amount of the SBA guarantee.

In the process of talking with someone at the SBA, you will discover other programs it offers that will help you start your business and manage your organization. For example, to apply for funding you will need a well-written business plan. Once you get the loan and move to the business start-up phase, you will have lots of questions that need to be answered (including setting up a computer system for your company). And you are sure you will need help in a number of areas as you operate your cupcake shop. Fortunately, the SBA can help with all of these management and technical-service tasks.

This assistance is available through a number of channels, including the SBA's extensive

Web site, online courses, and training programs. A full array of individualized services is also available. The Small Business Development Center (SBDC) assists current and prospective small business owners with business problems and provides free training and technical information on all aspects of small business management. These services are available at approximately one thousand locations around the country, many housed at colleges and universities.¹⁴⁰

If you need individualized advice from experienced executives, you can get it through the Service Corps of Retired Executives (SCORE). Under the SCORE program, a businessperson needing advice is matched with someone on a team of retired executives who work as volunteers. Together, the SBDC and SCORE help more than a million small businesspersons every year.¹⁴¹

Key Takeaways

- Business owners face numerous challenges, and the ability to meet them is a major factor in success (or failure). As a business owner, you should do the following:
 1. *Know your business.* Successful businesspeople are knowledgeable about the industry in which they operate, and they know who their competitors are.
 2. *Know the basics of business management.* To *manage* a business, you need to understand the functional areas of business—accounting, finance, management, marketing, and production.
 3. *Have the proper attitude.* You should believe in what you're doing and make a strong personal commitment to it.

4. *Get adequate funding.* Plan for the long term and work with lenders and investors to ensure that you'll have sufficient funds to get open, stay open during the start-up phase, and, ultimately, expand.
 5. *Manage your money effectively.* You need to pay attention to *cash flow*—money coming in and money going out—and you need to know how to gather the financial information that you require to run your business.
 6. *Manage your time efficiently.* You must develop time-management skills and learn how to delegate responsibility.
 7. *Know how to manage people.* You need to develop a positive working relationship with your employees, train them properly, and motivate them to provide quality goods or services.
 8. *Satisfy your customers.* Commit yourself to satisfying—or even exceeding—customer needs.
 9. *Know how to compete.* Find your niche in the marketplace, keep an eye on your competitors, and be prepared to react to changes in your business environment.
- Businesses fail for any number of reasons, but many experts agree that the vast majority of failures result from some combination of the following problems:
 1. *Bad business idea.* Like any idea, a business idea can be flawed, either in the conception or in the execution.
 2. *Cash problems.* Too many new businesses are underfunded.
 3. *Managerial inexperience or incompetence.* Many new business owners have no experience in running a business, and many have limited management skills.
 4. *Lack of customer focus.* Some owners fail to make the most of a small business's advantage in providing special attention to customers.
 5. *Inability to handle growth.* When a company grows, some owners fail to delegate work or to build an organizational structure that can handle increases in volume.

- Services available to current and prospective small business owners from the SBA include assistance in developing a business plan, starting a business, obtaining financing, and managing an organization.
- The **SBDC (Small Business Development Centers)** matches businesspeople needing advice with teams of retired executives who work as volunteers through the SCORE program.

Chapter 5 Review Questions

Multiple Choice:

- According to the SBA, which is not an advantage to starting a business?
 1. Be you own boss
 2. Achieve financial independence
 3. Work less hours
 4. Use your skills and knowledge
- Because you will need to develop working relationships with a variety of people, it is important to ask yourself _____.
 1. Am I a self-starter?
 2. How well do I get along with different personalities?
 3. How good am I at making decisions?
 4. Do I have the physical and emotional stamina?
- According to research, which is not one of the top four fears that prevent people from starting a business?
 1. Money
 2. Security
 3. Experience
 4. Competition
- This section of the business plan should explain what is important and what is appropriate in conducting company activities.
 1. Executive summary
 2. Industry analysis
 3. Mission statement and core values
 4. Management plan
- This critical section of the business plan focuses on target customers, pricing, distribution, and promotion.
 1. Good, Services, And The Production Process
 2. Marketing
 3. Financial Plan
 4. Industry Analysis

Short Answer:

1. What are five common reasons for starting a business?
2. Describe what the purpose of a business plan is.

Chapter 6 Managing for Business Success

What Do Managers Do?

Learning Outcome

1. Identify the four interrelated functions of management: planning, organizing, directing, and controlling.

You'll accomplish this task through management: the process of planning, organizing, directing, and controlling resources to achieve specific goals. A *plan* enables you to take your business concept beyond the idea stage. It does not, however, get the work *done*. You have to *organize* things if you want your plan to become a reality. You have to put people and other resources in place to make things happen. And because your note-taking venture is supposed to be better off with you in charge, you need to be a *leader* who can motivate your people to do well. Finally, to know whether things are in fact going well, you'll have to *control* your operations—that is, measure the results and compare them with the results that you laid out in your plan. gives you a good idea of the interrelationship between planning and the other functions that managers perform.

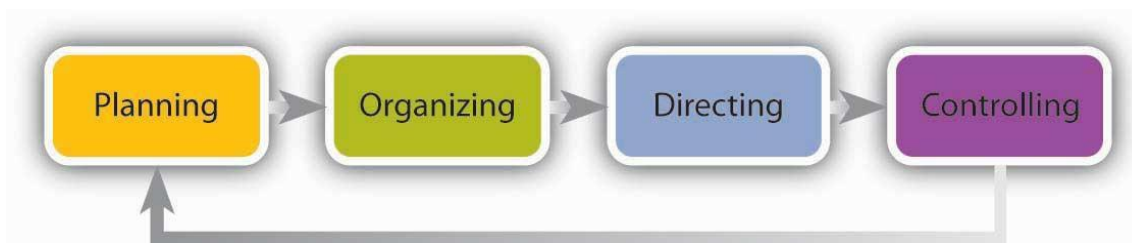


Figure 30 The Role of Planning

Functions of Management

If you visit any small or large company, not-for-profit organization, or government agency, you'll find managers doing the same things you'd be doing to run your note-taking business—*planning, organizing, directing, and controlling*. In the rest of the chapter, we'll look at these four interrelated functions in detail.

Key Takeaways

- Managers plan, organize, direct, and control resources to achieve specific goals.
- In **planning**, they set goals and determine the best way to achieve them.
- **Organizing** means allocating resources (people, equipment, and money) to carry out the company's plans.
- **Directing** is the process of providing focus for employees and motivating them to achieve organizational goals.
- **Controlling** involves comparing actual to expected performance and taking corrective action when necessary.

Planning

Learning Outcome

1. Understand the process by which a company develops and implements a strategic plan.

Without a plan, it's hard to succeed at anything. The reason is simple: if you don't know where you're going, you can't really move forward. Successful managers decide where they want to be and then figure out how to get there. In planning, managers set goals and determine the best way to achieve them. As a result of the planning process, everyone in the organization knows what should be done, who should do it, and how it should be done.

Developing a Strategic Plan

Coming up with an idea—say, starting a note-taking business—is a good start, but it's only a start. Planning for it is a step forward. Planning begins at the highest level and works its way down through the organization. Step one is usually called strategic planning, which is the process of establishing an overall course of action. To begin this process, you should ask yourself a couple of very basic questions: Why, for example, does the organization exist? What value does it create? Sam Walton posed these questions in the process of founding Wal-Mart: his new chain of stores would exist to offer customers the lowest prices with the best possible service.¹⁴²

After you've identified the purpose of your company, you're ready to take the remaining steps in the strategic-planning process:

1. Write a mission statement that tells customers, employees, and others why your organization exists.
2. Identify core values or beliefs that will guide the behavior of members of the organization.
3. Assess the company's strengths, weaknesses, opportunities, and threats.
4. Establish goals and objectives, or performance targets, to direct all the activities that you'll perform to achieve your mission.
5. Develop and implement tactical and operational plans to achieve goals and objectives.

In the next few sections, we'll examine these components of the strategic-planning process.

Mission Statement

As we saw in an earlier chapter, the *mission statement* describes the purpose of your organization—the reason for its existence. It tells the reader what the organization is committed to doing. It can be very concise, like the one from Mary Kay Inc. (the cosmetics company): “To enrich the lives of women around the world.”¹⁴³ Or it can be as detailed as the one from Harley-Davidson: “We fulfill dreams inspired by the many roads of the world by providing extraordinary motorcycles and customer experiences. We fuel the passion for freedom in our customers to express their own individuality.”¹⁴⁴

What about Notes-4-You? What should your mission statement say? A simple, concise mission statement for your enterprise could be the following: “To provide high-quality class notes to college students.” On the other hand, you could prepare a more detailed statement that explains what the company is committed to doing, who its customers are, what its focus is, what goods or services it provides, and how it serves its customers. In that case, your mission statement might be the following:

“Notes-4-You is committed to earning the loyalty of college students through its focus on customer service. It provides high-quality, dependable, competitively priced class notes that help college students master complex academic subjects.”

Core Values

Having defined your mission, your next step is to ask, what does this organization stand for? What values will define it? What principles should guide our actions as we build and operate the business? In Chapter 2 "Business Ethics and Social Responsibility", we explained that the small set of guiding principles that you identify as crucial to your company are known as *core values*—fundamental beliefs about what’s important and what is and isn’t appropriate in conducting company activities. Core values affect the overall planning processes and operations. At Volvo, for example, three core values— safety, quality, and environmental care—define the firm’s “approach to product development, design and production.”¹⁴⁵ Core values should also guide the behavior of every individual in the organization. Coca-Cola, for instance, reports that its stated core values— leadership, collaboration, integrity, accountability, passion, diversity and quality—tell employees exactly what behaviors are acceptable.¹⁴⁶ How do companies communicate core values to employees and hold them accountable for putting those values into practice? They link core values to performance evaluations and compensation.

In choosing core values for Notes-4-You, you’re determined not to fall back on some list of the world’s most popular core values: ethics/integrity, accountability, respect for others, and open communication.¹⁴⁷ You want yours to be unique to Notes-4-You. After some thought, you settle on *teamwork*, *trust*, and *dependability*. Why these three? As you plan your business, you realize that it will need a workforce that functions as a team, trusts each other, and can be depended on to satisfy customers. In building your workforce, you’ll seek employees who’ll embrace these values.

Conduct a SWOT Analysis

The next step in the strategic-planning process is to assess your company’s fit with its environment. A common approach to *environmental analysis* is matching the strengths of your business with the opportunities available to it. It’s called SWOT analysis because it calls for analyzing an organization’s Strengths, Weaknesses, Opportunities, and Threats.

It begins with an examination of *external* factors that could influence the company in either a positive or a negative way. These could include economic conditions, competition, emerging technologies, laws and regulations, and customers' expectations.

One purpose of assessing the external environment is to identify both *opportunities* that could benefit the company and *threats* to its success. For example, a company that manufactures children's bicycle helmets would view a change in federal law requiring all children to wear helmets as an opportunity. The news that two large sports-equipment companies were coming out with bicycle helmets would be a threat.

The next step is to evaluate the company's strengths and weaknesses. *Strengths* might include a motivated workforce, state-of-the-art technology, impressive managerial talent, or a desirable location. The opposite of any of these strengths (poor workforce, obsolete technology, incompetent management, or poor location) could signal a potential *weakness*. Armed with a good idea of external opportunities and threats, as well as internal strengths and weaknesses, managers want to capitalize on opportunities by taking advantage of organizational strengths. Likewise, they want to protect the organization from both external threats and internal weaknesses.

Let's start with our strengths. Now that we know what they are, how do we match them with our available opportunities (while also protecting ourselves from our threats and overcoming our weaknesses)? Here's a possibility: By providing excellent service and price while we're still small (with few customers and low costs), we can solidify our position on campus. When the market grows (as it will, because of the increase in the number of classes—especially those at 8:00 a.m.—and increases in student enrollment), we'll have built a strong reputation and will put ourselves in a position to grow. So even if a competitor comes to campus (a threat), we'll be the preferred supplier of class notes. This strategy will work only if we make sure that our note-takers are dependable and that we don't alienate the faculty or administration.

Set Goals and Objectives

Your mission statement affirms what your organization is *generally* committed to doing, but it doesn't tell you *how* to do it. So the next step in the strategic-planning process is establishing goals and objectives. Goals are major accomplishments that the company

wants to achieve over a long period (say, five years). Objectives are shorter-term performance targets that direct the activities of the organization toward the attainment of a goal. They should be clearly stated, attainable, and measurable: they should give target dates for the completion of tasks and stipulate who's responsible for taking necessary actions.¹⁴⁸

An organization will have a number of goals and related objectives. Some will focus on financial measures, such as profit maximization and sales growth. Others will target operational efficiency or quality control. Still others will govern the company's relationships with its employees, its community, its environment, or all three. Finally, goals and objectives change over time. As a firm reassesses its place in its business environment, it rethinks not only its mission but also its approach to fulfilling it. The reality of change was a major theme when the late McDonald's CEO Jim Cantalupo explained his goal to revitalize the company:

"The world has changed. Our customers have changed. We have to change too. Growth comes from being better, not just expanding to have more restaurants. The new McDonald's is focused on building sales at existing restaurants rather than on adding new restaurants. We are introducing a new level of discipline and efficiency to all aspects of the business and are setting a new bar for performance."¹⁴⁹ This change in focus was accompanied by specific performance objectives—annual sales growth of 3 to 5 percent and income growth of 6 to 7 percent at existing restaurants, plus a five-point improvement (based on customer surveys) in speed of service, friendliness, and food quality.

In setting strategic goals and performance objectives for Notes-4-You, you should keep things simple. Because you know you need to make money to stay in business, you could include a financial goal (and related objectives). Your mission statement promises "high-quality, dependable, competitively priced class notes," so you could focus on the quality of the class notes that you'll be taking and distributing. Finally, because your mission is to serve students, one goal could be customer oriented. When all's said and done, your list of goals and objectives might look like this:

- **Goal 1:** Achieve a 10 percent return on profits in your first five years.

- *Objective:* Sales of \$20,000 and profit of \$2,000 for the first twelve months of operations.
- **Goal 2:** Produce a high-quality product.
 - *Objective:* First-year satisfaction scores of 90 percent or higher on quality of notes (based on survey responses to three measures—understandability, readability, and completeness).
- **Goal 3:** Attain 98 percent customer satisfaction by the end of your fifth year.
 - *Objective:* Making notes available within two days after class, 95 percent of the time.

Develop Tactical and Operational Plans

The planning process begins at the top of the organization, where upper-level managers create a strategic plan, but it doesn't end there. The *execution* of the strategic plan involves managers at all levels.

Tactical Plans

The overall plan is broken down into more manageable, shorter-term components called tactical plans. These plans specify the activities and allocation of resources (people, equipment, money) needed to implement the overall strategic plan over a given period. Often, a long-range strategic plan is divided into several tactical plans; a five-year strategic plan, for instance, might be implemented as five one-year tactical plans.

Operational Plans

The tactical plan is then broken down into various operational plans that provide detailed action steps to be taken by individuals or groups to implement the tactical plan and, consequently, the strategic plan. Operational plans cover only a brief period—say, a week or a month. At Notes-4-You, for example, note-takers might be instructed to turn in typed class notes five hours earlier than normal on the last day of the semester (an operational guideline). The goal is to improve the customer-satisfaction score on dependability (a *tactical goal*) and, as a result, to earn the loyalty of students through attention to customer service (a *strategic goal*).

Plan for Contingencies and Crises

Even with great planning, things don't always turn out the way they're supposed to. Perhaps your plans were flawed, or maybe you had great plans but something in the environment shifted unexpectedly. Successful managers anticipate and plan for the unexpected. Dealing with uncertainty requires *contingency planning* and *crisis management*.

Contingency Planning

With contingency planning, managers identify those aspects of the business that are most likely to be adversely affected by change. Then, they develop alternative courses of action in case an anticipated change does occur. You probably do your own contingency planning: for example, if you're planning to take in a sure-fire hit movie on its release date, you may decide on an alternative movie in case you can't get tickets to your first choice.

Crisis Management

Organizations also face the risk of encountering crises that require immediate attention. Rather than waiting until such a crisis occurs and then scrambling to figure out what to do, many firms practice crisis management. Some, for instance, set up teams trained to deal with emergencies. Members gather information quickly and respond to the crisis while everyone else carries out his or her normal duties. The team also keeps the public, the employees, the press, and government officials informed about the situation and the company's response to it.¹⁵⁰

An example of how to handle crisis management involves Wendy's. After learning that a woman claimed she found a fingertip in a bowl of chili she bought at a Wendy's restaurant in San Jose, California, the company's public relations team responded quickly. Within a few days, the company announced that the finger didn't come from an employee or a supplier. Soon after, the police arrested the woman and charged her with attempted grand larceny for lying about how the finger got in her bowl of chili and trying to extort \$2.5 million from the company. But the crisis wasn't over for Wendy's. The incident was plastered all over the news as a grossed-out public sought an answer to the question, "Whose finger is (or was) it?" A \$100,000 reward was offered by Wendy's to anyone with information that would help the police answer this question. The challenge Wendy's faced was how to entice customers to return to its fifty San Francisco–area restaurants (where sales had

plummeted) while keeping a low profile nationally. It accomplished this by giving out free milkshakes and discount coupons to customers in the affected regions and, to avoid calling attention to the missing finger, by making no changes in its national advertising. The crisis-management strategy worked and the story died down (though it flared up temporarily when the police arrested the woman's husband, who allegedly bought the finger from a coworker who had severed it in an accident months earlier).¹⁵¹

Even with crisis-management plans in place, however, it's unlikely that most companies will emerge from a damaging or potentially damaging episode as unscathed as Wendy's did. For one thing, the culprits in the Wendy's case were caught, and the public is willing to forgive an organization it views as a victim. Given the current public distrust of corporate behavior, however, companies whose reputations have suffered due to questionable corporate judgment don't fare as well. These companies include the international oil company, BP, whose CEO, Tony Hayward, did a disastrous job handling the crisis created when a BP controlled oil rig exploded in the Gulf Coast killing eleven workers and creating the largest oil spill in U.S. history. Hayward's lack of sensitivity will be remembered forever; particularly his response to a reporter's question on what he would tell those whose livelihoods were ruined: "We're sorry for the massive disruption it's caused their lives. There's no one who wants this over more than I do. I would like my life back." His comment was obviously upsetting to the families of the eleven men who lost their lives on the rig and had no way to get their lives back.¹⁵²

Then, there are the companies at which executives have crossed the line between the unethical to the downright illegal—Arthur Andersen, Enron, and Bernard L. Madoff Investment Securities, to name just a few. Given the high risk associated with a crisis, it should come as no surprise that contemporary managers spend more time anticipating crises and practicing their crisis-management responses.

Key Takeaways

- Successful managers decide where they want the organization to go and then determine how to get there.
- **Planning** for a business starts at the top and works its way down.
- It begins with **strategic planning**—the process of establishing an overall course of action.
- Step one is identifying the purpose of the organization.
- Then, management is ready to take the remaining steps in the strategic planning process:
 1. Prepare a **mission statement** that describes the purpose of the organization and tells customers, employees, and others what it's committed to doing.
 2. Select the **core values** that will guide the behavior of members of the organization by letting them know what is and isn't appropriate and important in conducting company activities.
 3. Use **SWOT analysis** to assess the company's strengths and weaknesses and its fit with the external environment.
 4. Set **goals** and **objectives**, or performance targets, to direct all the activities needed to achieve the organization's mission.
 5. Develop **tactical plans** and **operational plans** to implement objectives.

Organizing

Learning Outcome

1. Discuss various options for organizing a business, and create an organization chart.

Now that you've developed a strategic plan for Notes-4-You, you need to organize your company so that it can implement your plan. A manager engaged in organizing allocates *resources* (people, equipment, and money) to achieve a company's plans. Successful managers make sure that all the activities identified in the planning process are assigned to some person, department, or team and that everyone has the resources needed to perform assigned activities.

Levels of Management: How Managers Are Organized



Figure 31 Levels of Management

A typical organization has several layers of management. Think of these layers as forming a pyramid like the one in Figure 2 "Levels of Management", with top managers occupying the narrow space at the peak, first-line managers the broad base, and middle-managers the levels in between. As you move up the

pyramid, management positions get more demanding, but they carry more authority and responsibility (along with more power, prestige, and pay). Top managers spend most of their time in planning and decision making, while first-line managers focus on day-to-day operations. For obvious reasons, there are far more people with positions at the base of the pyramid than there are with jobs at the other two levels (as you get to the top, there are only a few positions). Let's look at each management level in more detail.

Top Managers

Top managers are responsible for the health and performance of the organization. They set the objectives, or performance targets, designed to direct all the activities that must be performed if the company is going to fulfill its mission. Top-level executives routinely scan the external environment for opportunities and threats, and they redirect company efforts when needed. They spend a considerable portion of their time planning and making major decisions. They represent the company in important dealings with other businesses and government agencies, and they promote it to the public. Job titles at this level typically include *chief executive officer (CEO)*, *chief financial officer (CFO)*, *chief operating officer (COO)*, *president*, and *vice president*.

Middle Managers

As the name implies, middle managers are in the “middle” of the management hierarchy: They report to top management and oversee the activities of first-line managers. They’re responsible for developing and implementing activities and allocating the resources needed to achieve the objectives set by top management. Common job titles include *operations manager*, *division manager*, *plant manager*, and *branch manager*.

First-Line Managers

First-line managers supervise employees and coordinate their activities to make sure that the work performed throughout the company is consistent with the plans of both top and middle management. They’re less involved in planning than higher-level managers and more involved in day-to-day operations. It’s at this level that most people acquire their first managerial experience. The job titles vary considerably but include such designations as *department head*, *group leader*, *office manager*, *foreman*, and *supervisor*.

Let’s take a quick survey of the management hierarchy at Notes-4-You. As president, you are, of course, a member of *top management*, and you’re responsible for the overall performance of your company. You spend much of your time setting objectives, or performance targets, to ensure that the company meets the goals you’ve set for it—increased sales, higher-quality notes, and timely distribution.

Several *middle managers* report to you, including your operations manager. As a middle manager, this individual focuses on implementing two of your objectives: producing high-quality notes and distributing them to customers in a timely manner. To accomplish this task, the operations manager oversees the work of two *first-line managers*—the note-taking supervisor and the copying supervisor. Each first-line manager supervises several non-managerial employees to make sure that their work is consistent with the plans devised by top and middle management.

Organizational Structure: How Companies Get the Job Done

The organizing process raises some important questions: What jobs need to be done? Who does what? Who reports to whom? What are the formal relationships among people in the organization? You provide answers to these questions by developing an organizational structure: an arrangement of positions that’s most appropriate for your

company at a specific point in time. Remember, given the rapidly changing environment in which businesses operate, a structure that works today might be outdated tomorrow. That's why you hear so often about companies restructuring—altering existing organizational structures to become more competitive under conditions that have changed. In building an organizational structure, you engage in two activities: *job specialization* (dividing tasks into jobs) and *departmentalization* (grouping jobs into units). We'll now see how these two processes are accomplished.

Specialization

The first step in designing an organizational structure is twofold:

1. Identifying the activities that need to be performed in order to achieve organizational goals.
2. Breaking down these activities into tasks that can be performed by individuals or groups of employees.

This twofold process of organizing activities into clusters of related tasks that can be handled by certain individuals or groups is called specialization. Its purpose is to improve efficiency.

Would specialization make Notes-4-You more efficient? You could have each employee perform all tasks entailed by taking and selling notes. Each employee could take notes in an assigned class, type them up, get them copied, and sell them outside the classroom at the start of the next class meeting. The same person would keep track of all sales and copying costs and give any profit—sales minus copying costs minus compensation—to you. The process seems simple, but is it really *efficient*? Will you earn the maximum amount of profit? Probably not. Even a company as small as Notes-4-You can benefit from specialization. It would function more efficiently if some employees specialized in taking notes, others in copying and packaging them, and still others in selling them. Higher-level employees could focus on advertising, accounting, finance, and human resources.

Obviously, specialization has advantages. In addition to increasing efficiency, for example, it results in jobs that are easier to learn. But it has disadvantages, too. Doing the same thing over and over bores people and will eventually leave employees dissatisfied with

their jobs. Before long, you'll notice decreased performance and increased absenteeism and turnover.

Departmentalization

The next step in designing an organizational structure is departmentalization—grouping specialized jobs into meaningful units. Depending on the organization and the size of the work units, they may be called *divisions*, *departments*, or just plain *groups*. Traditional groupings of jobs result in different organizational structures, and for the sake of simplicity, we'll focus on two types—*functional* and *divisional organizations*.

Functional Organization

A functional organization groups together people who have comparable skills and perform similar tasks. This form of organization is fairly typical for small to medium-size companies, which group their people by business functions: accountants are grouped together, as are people in finance, marketing and sales, human resources, production, and research and development. Each unit is headed by an individual with expertise in the unit's particular function. The head of an accounting department, for example, will be a senior accountant; the head of a hospital nursing unit will obviously be an experienced nurse. This structure is also appropriate for nonprofits. Think about your school, for instance: mathematics teachers are in the math department, history teachers are in the history department, those who run athletic programs are in the athletic department, and librarians work at the library.

If Notes-4-You adopted a functional approach to departmentalization, jobs might be grouped into four clusters:

- Human resources (hiring, training, and evaluating employees)
- Operations (overseeing notetakers and copiers)
- Marketing (arranging for advertising, sales, and distribution)
- Accounting (handling cash collection and disbursement)

There are a number of advantages to the functional approach. The structure is simple to understand and enables the staff to specialize in particular areas; everyone in the marketing group would probably have similar interests and expertise. But homogeneity also has drawbacks: it can hinder communication and decision making between units and

even promote interdepartmental conflict. The marketing department, for example, might butt heads with the accounting department because marketers want to spend as much as possible on advertising, while accountants want to control costs. Marketers might feel that accountants are too tight with funds, and accountants might regard marketers as spendthrifts.

Divisional Organization

Large companies often find it unruly to operate as one large unit under a functional organizational structure. Sheer size makes it difficult for managers to oversee operations and serve customers. To rectify this problem, most large companies are structured as divisional organizations made up of several smaller, self-contained units, or divisions, which are accountable for their own performance. Each division functions autonomously because it contains all the functional expertise (production, marketing, accounting, finance, human resources) needed to meet its objectives. The challenge is to find the most appropriate way of structuring operations to achieve overall company goals. Toward this end, divisions can be formed according to *products, customers, processes, or geography*.

Product Division

Product division means that a company is structured according to its product lines. General Motors, for example, has four product-based divisions: Buick, Cadillac, Chevrolet, and GMC.¹⁵³ Each division has its own research and development group, its own manufacturing operations, and its own marketing team. This allows individuals in the division to focus all their efforts on the products produced by their division. A downside is that it results in higher costs as corporate support services (such as accounting and human resources) are duplicated in each of the four divisions.

Customer Division

Some companies prefer a customer division structure because it enables them to better serve their various categories of customers. Thus, Johnson & Johnson's two hundred or so operating companies are grouped into three customer-based business segments: consumer business (personal-care and hygiene products sold to the general public), pharmaceuticals (prescription drugs sold to pharmacists), and professional business (medical devices and diagnostics products used by physicians, optometrists, hospitals, laboratories, and clinics).¹⁵⁴

Process Division

If goods move through several steps during production, a company might opt for a process division structure. This form works well at Bowater Thunder Bay, a Canadian company that harvests trees and processes wood into newsprint and pulp. The first step in the production process is harvesting and stripping trees. Then, large logs are sold to lumber mills and smaller logs chopped up and sent to Bowater's mills. At the mill, wood chips are chemically converted into pulp. About 90 percent is sold to other manufacturers (as raw material for home and office products), and the remaining 10 percent is further processed into newspaper print. Bowater, then, has three divisions: tree cutting, chemical processing, and finishing (which makes newsprint).¹⁵⁵

Geographical Division

Geographical division enables companies that operate in several locations to be responsive to customers at a local level. McDonald's, for example, is organized according to the regions of the world in which it operates. In the United States, the national unit is further subdivided into three geographic operating divisions: east, west and central.¹⁵⁶ (This approach might be appealing to Notes-4-You if it expands to serve schools around the country.)

There are pluses and minuses associated with divisional organization. On the one hand, divisional structure usually enhances the ability to respond to changes in a firm's environment. If, on the other hand, services must be duplicated across units, costs will be higher. In addition, some companies have found that units tend to focus on their own needs and goals at the expense of the organization as a whole.

The Organization Chart

Once an organization has set its structure, it can represent that structure in an organization chart: a diagram delineating the interrelationships of positions within the organization. Having decided that Notes-4-You will adopt a functional structure, you might create the organization chart shown in Figure 3 "Organization Chart for Notes-4-You".

Begin by putting yourself at the top of the chart, as the company's president. Then fill in the level directly below your name with the names and positions of the people who work directly *for you*—your accounting, marketing, operations, and human resources managers.

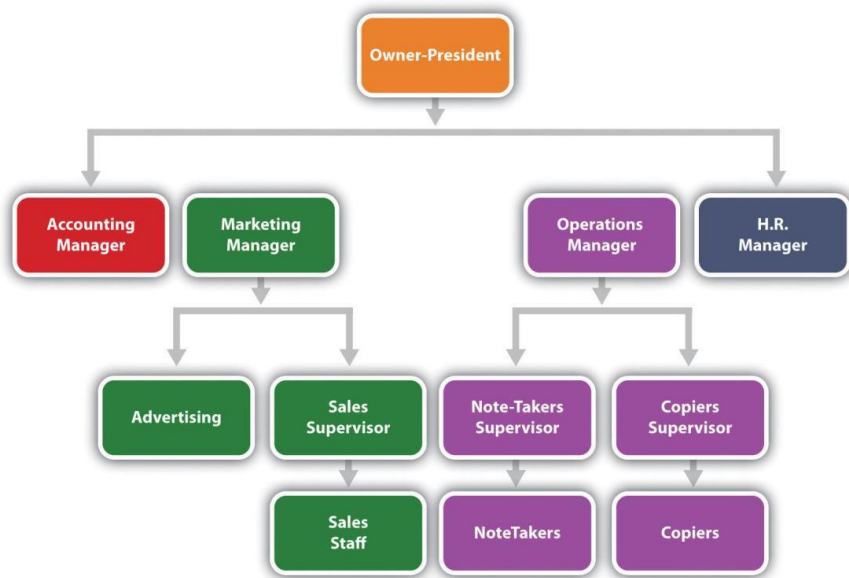


Figure 32 Organization Chart for Notes-4-You

The next level identifies the people who work for these managers. Because you've started out small, neither your accounting manager nor your human resources manager will be currently managing anyone directly. Your marketing manager, however, will oversee one person in advertising and a sales supervisor (who, in turn,

oversees the sales staff). Your operations manager will oversee two individuals—one to supervise note-takers and one to supervise the people responsible for making copies.

Reporting Relationships

With these relationships in mind, you can now draw lines to denote reporting relationships, or patterns of formal communication. Because four managers report to you, you'll be connected to four positions; that is, you'll have four direct "reports." Your marketing and operations managers will each be connected to two positions and their supervisors to one position each. The organization chart shows that if a member of the sales staff has a problem, he or she will report it to the sales supervisor. If the sales supervisor believes that the problem should be addressed at a higher level, then he or she will report it to the marketing manager.

Theoretically, you will communicate only with your four direct reports, but this isn't the way things normally work. Behind every formal communication network there lies a network of informal communications—unofficial relationships among members of an organization. You might find that over time, you receive communications directly from members of the sales staff; in fact, you might encourage this line of communication. Now let's look at the chart of an organization that relies on a divisional structure based on goods or services produced—say, a theme park. The top layers of this company's organization chart might

look like the one in Figure 6.6 "Organization Charts for Divisional Structures"(a). We see that the president has two direct reports—a vice president in charge of rides and a vice president in charge of concessions. What about a bank that's structured according to its customer base? The bank's organization chart would begin like the one in Figure 4 "Organization Charts for Divisional Structures"(b). Once again, the company's top manager has two direct reports, in this case a VP of retail-customer accounts and a VP of commercial-customer accounts.

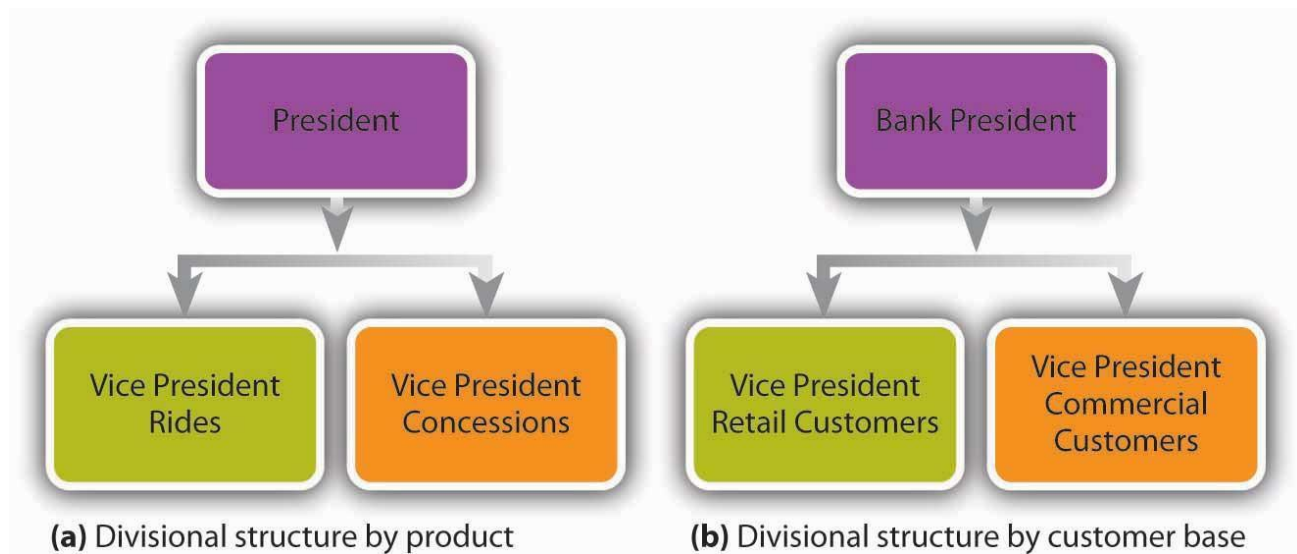


Figure 33 Organization Charts for Divisional Structures

Over time, companies revise their organizational structures to accommodate growth and changes in the external environment. It's not uncommon, for example, for a firm to adopt a functional structure in its early years. Then, as it becomes bigger and more complex, it might move to a divisional structure—perhaps to accommodate new products or to become more responsive to certain customers or geographical areas. Some companies might ultimately rely on a combination of functional and divisional structures. This could be a good approach for a credit card company that issues cards in both the United States and Europe. A skeleton of this firm's organization chart might look like the one in Figure 6.7.



Figure 34 Organization Chart: Combination Divisional and Functional Structures

Lines of Authority

You can learn a lot about a firm's reporting and authority relationships by looking at its organization chart. To whom does a particular person report? Does each person report to one or more supervisors? How many people does a manager supervise? How many layers are there, for example, between the top managerial position and the lowest managerial level?

Chain of Command

The vertical connecting lines in the organization chart show the firm's chain of command: the authority relationships among people working at different levels of the organization. That is to say, they show *who reports to whom*. When you're examining an organization chart, you'll probably want to know whether each person reports to one or more supervisors: to what extent, in other words, is there *unity of command*? To understand why unity of command is an important organizational feature, think about it from a personal standpoint. Would you want to report to more than one boss? What happens if you get conflicting directions? Whose directions would you follow?

There are, however, conditions under which an organization and its employees can benefit by violating the unity-of-command principle. Under a matrix structure, for example, employees from various functional areas (product design, manufacturing, finance, marketing, human resources, etc.) form teams to combine their skills in working on a specific project or product. This matrix organization chart might look like the one in the

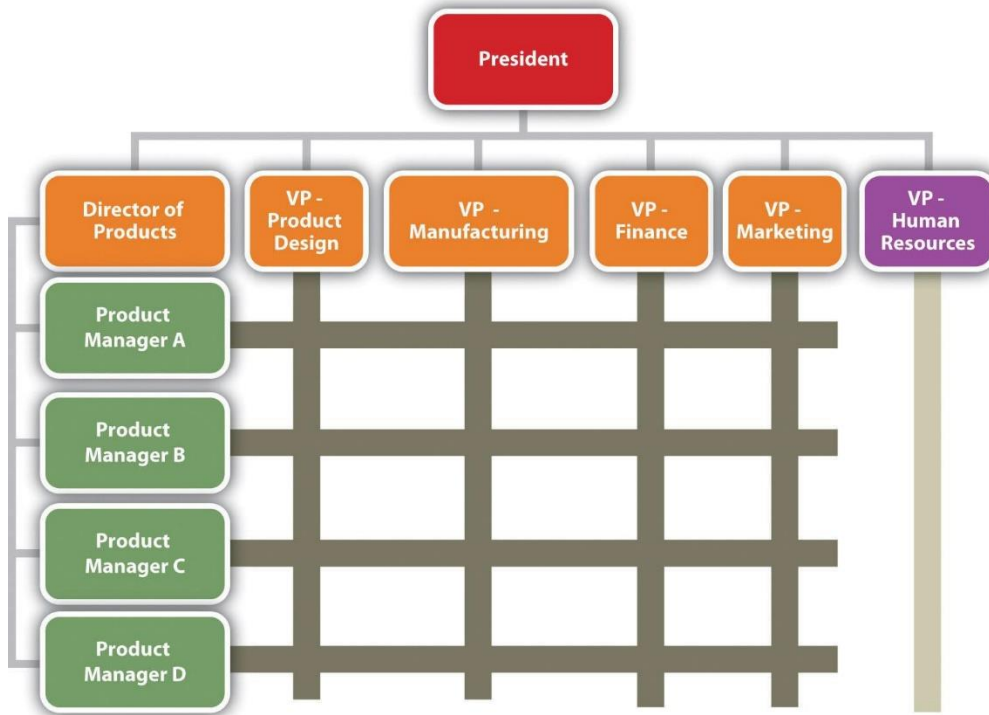


Figure 35 Organization Chart: Matrix Structure

following figure.

Nike sometimes uses this type of arrangement. To design new products, the company may create product teams made up of designers, marketers, and other specialists with expertise in particular sports categories—say,

running shoes or basketball shoes. Each team member would be evaluated by both the team manager and the head of his or her functional department.

Span of Control

Another thing to notice about a firm's chain of command is the number of layers between the top managerial position and the lowest managerial level. As a rule, new organizations (such as Notes-4-You) have only a few layers of management—an organizational structure that's often called *flat*. Let's say, for instance, that a member of the Notes-4-You sales staff wanted to express concern about slow sales among a certain group of students. That person's message would have to filter upward through only two management layers—the sales supervisor and the marketing manager—before reaching the president.

As a company grows, however, it tends to add more layers between the top and the bottom; that is, it gets *taller*. Added layers of management can slow down communication and decision making, causing the organization to become less efficient and productive. That's one reason why many of today's organizations are restructuring to become flatter.

There are trade-offs between the advantages and disadvantages of flat and tall

organizations. Companies determine which trade-offs to make according to a principle called span of control, which measures the number of people reporting to a particular manager. If, for example, you remove layers of management to make your organization flatter, you end up increasing the number of positions reporting to a particular supervisor. If you refer back to the organization chart in Figure 4 "Organization Chart for Notes-4-You", you'll recall that, under your present structure, four managers report to you as the president of Notes-4-You: the heads of accounting, marketing, operations, and human resources. In turn, two of these managers have positions reporting to them: the advertising manager and sales supervisor report to the marketing manager, while the notetaker's supervisor and the copier's supervisor report to the operations manager. Let's say that you remove a layer of management by getting rid of the marketing and operations managers. Your organization would be flatter, but what would happen to your workload? As president, you'd now have six direct reports rather than four: accounting manager, advertising manager, sales manager, notetaker supervisor, copier supervisor, and human resources manager.

What's better—a *narrow* span of control (with few direct reports) or a *wide* span of control (with many direct reports)? The answer to this question depends on a number of factors, including frequency and type of interaction, proximity of subordinates, competence of both supervisor and subordinates, and the nature of the work being supervised. For example, you'd expect a much wider span of control at a nonprofit call center than in a hospital emergency room.

Delegating Authority

Given the tendency toward flatter organizations and wider spans of control, how do managers handle increased workloads? They must learn how to handle delegation—the process of entrusting work to subordinates. Unfortunately, many managers are reluctant to delegate. As a result, they not only overburden themselves with tasks that could be handled by others, but they also deny subordinates the opportunity to learn and develop new skills.

Responsibility and Authority

As owner of Notes-4-You, you'll probably want to control every aspect of your business, especially during the start-up stage. But as the organization grows, you'll have to assign

responsibility for performing certain tasks to other people. You'll also have to accept the fact that *responsibility* alone—the duty to perform a task—won't be enough to get the job done. You'll need to grant subordinates the *authority* they require to complete a task—that is, the power to make the necessary decisions. (And they'll also need sufficient resources.) Ultimately, you'll also hold your subordinates accountable for their performance.

Centralization and Decentralization

If and when your company expands (say, by offering note-taking services at other schools), you'll have to decide whether most decisions should still be made by individuals at the top or delegated to lower-level employees. The first option, in which most decision making is concentrated at the top, is called centralization. The second option, which spreads decision making throughout the organization, is called decentralization.

Let's say that you favor decentralizing Notes-4-You some four or five years down the road, when the company has expanded. Naturally, there are some decisions—such as strategic planning—that you won't delegate to lower-level employees, but you could certainly delegate the management of copy-center operations. In fact, putting someone in charge of this function would probably improve customer satisfaction, because copy-center customers would be dealing directly with the manager. It would also give the manager valuable decision-making experience, and while he or she is busy making daily decisions about the copy center, you'll have more time to work on higher-level tasks. The more you think about the possibility of decentralizing your company, the more you like the idea. First, though, you have to see it through its difficult start-up years.

Key Takeaways

- Managers coordinate the activities identified in the planning process among individuals, departments, or other units and allocate the resources needed to perform them.
- Typically, there are three levels of management: **top managers**, who are responsible for overall performance; **middle managers**, who report to top managers and oversee lower-level managers; and **first-line managers**, who supervise employees to make sure that work is performed correctly and on time.

- Management must develop an **organizational structure**, or arrangement of people within the organization, that will best achieve company goals.
- The process begins with **specialization**—dividing necessary tasks into jobs; the principle of grouping jobs into units is called **departmentalization**.
- Units are then grouped into an appropriate organizational structure.
 - Functional organization** groups people with comparable skills and tasks;
 - divisional organization** creates a structure composed of self-contained units based on **product, customer, process, or geographical division**. Forms of organizational division are often combined.
- An organization's structure is represented in an **organization chart**—a diagram showing the interrelationships of its positions.
- This chart highlights the **chain of command**, or authority relationships among people working at different levels.
- It also shows the number of layers between the top and lowest managerial levels. 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 report to each manager.

Directing

Learning Outcome

1. Explain how managers direct others and motivate them to achieve company goals.

The third management function is directing—providing focus and direction to others and motivating them to achieve organizational goals. As owner and president of Notes-4- You, you might think of yourself as an orchestra leader. You have given your musicians (employees) their sheet music (plans). You've placed them in sections (departments) and arranged the sections (organizational structure) so the music will sound as good as possible. Now your job is to tap your baton and lead the orchestra so that its members make beautiful music together.¹⁵⁷

Leadership Styles

Actually, it's fairly easy to pick up a baton, cue each section, and strike up the band. But it doesn't follow that the music will sound good. What if your cues are ignored or misinterpreted or ambiguous? Maybe your musicians don't like your approach to making music and will just walk away. On top of everything else, you don't simply want to make music: you want to inspire your musicians to make *great* music. How do you accomplish this goal? How do you become an effective leader? What style, or approach, should you use to motivate others to achieve organizational goals?

Unfortunately, there are no definitive answers to questions like these. Over time, every manager refines his or her own leadership style, or way of interacting with and influencing others. Despite a vast range of personal differences, leadership styles tend to reflect one of the following approaches to directing and motivating people: the *autocratic*, the *democratic*, or the *laissez-faire*. Let's see how managerial styles reflect each of them in a work situation.

- *Autocratic style*. Managers who have developed an autocratic leadership style tend to make decisions without soliciting input from subordinates. They exercise authority and expect subordinates to take responsibility for performing the required tasks without undue explanation.
- *Democratic style*. Managers who favor a democratic leadership style generally seek input from subordinates while retaining the authority to make the final decisions. They're also more likely to keep subordinates informed about things that affect their work.
- *Laissez-faire style*. In practicing a laissez-faire leadership style, managers adopt a "hands-off" approach and provide relatively little direction to subordinates. They may advise employees but usually give them considerable freedom to solve problems and make decisions on their own.

At first glance, you'd probably not want to work for an autocratic leader. After all, you certainly don't want to be told what to do without having any input. You probably like the idea of working for a democratic leader; it's flattering to be asked for your input. Though

working in a laissez-faire environment might seem a little unsettling at first, the opportunity to make your own decisions is appealing.

In general, your assessments of the three leadership styles would be accurate. Employees generally dislike working for autocratic leaders; they like working for democratic leaders, and they find working for laissez-faire leaders rewarding (as long as they feel they can handle the job). But there are situations when these generalities don't hold.

To learn what these situations are, let's turn things around and pretend you're the leader. To make it applicable to your current life, we'll say that you're leading a group of fellow students in a team project for your class. Are there times when it would be best for you to use an autocratic leadership style? What if your team was newly formed, unfamiliar with what needs to be done, under a tight deadline, and looking to you for direction? In this situation, you might find it appropriate to follow an autocratic leadership style (on a temporary basis) and assign tasks to each member of the group.

Now let's look at the leadership style you probably prefer—the democratic leadership style. Can you think of a situation where this style would *not* work for your team? What if the members of your team are unmotivated, don't seem interested in providing input, and aren't getting along? It might make sense to move away from a democratic style of leadership (temporarily) and delegate specific tasks to each member of the group that they can do on their own.

How about laissez-faire leadership? Will this always work with your group? Not always. It will work if your team members are willing and able to work independently and welcome the chance to make decisions. Otherwise, it could cause the team to miss deadlines or do poorly on the project.

The point being made here is that no one leadership style is effective all the time for all people. While the democratic style is viewed as the most appropriate (as is the laissez-faire style, to a lesser extent), there are times when following an autocratic style is better. Good leaders learn how to adjust their styles to fit both the situation and the individuals being directed.

Transformational Leadership

Theories on what constitutes effective leadership evolve over time. One theory that has received a lot of attention in the last decade contrasts two leadership styles: *transactional* and *transformational*. So-called transactional leaders exercise authority based on their rank in the organization. They let subordinates know what's expected of them and what they will receive if they meet stated objectives. They focus their attention on identifying mistakes and disciplining employees for poor performance. By contrast, transformational leaders mentor and develop subordinates, providing them with challenging opportunities, working one-on-one to help them meet their professional and personal needs, and encouraging people to approach problems from new perspectives. They stimulate employees to look beyond personal interests to those of the group.

So, which leadership style is more effective? You probably won't be surprised by the opinion of most experts. In today's organizations, in which team building and information sharing are important and projects are often collaborative in nature, transformational leadership has proven to be more effective. Modern organizations look for managers who can develop positive relationships with subordinates and motivate employees to focus on the interests of the organization.¹⁵⁸

Key Takeaways

- A manager's **leadership style** varies depending on the manager, the situation, and the people being directed. There are three common styles.
 1. Using an **autocratic style**, a manager tends to make decisions without soliciting input and expects subordinates to follow instructions without undue explanation.
 2. Managers who prefer a **democratic style** seek input into decisions.
 3. Exercising a **laissez-faire style**, the manager provides no more guidance than necessary and lets subordinates make decisions and solve problems.
- One current leadership theory focuses on two contrasting leadership styles: transactional and transformational.

1. Managers adopting a **transactional style** exercise authority according to their rank in the organization, let subordinates know what's expected of them, and step in when mistakes are made.
2. Practicing a **transformational style**, managers mentor and develop subordinates and motivate them to achieve organizational rather than merely personal goals. Transformational leadership is effective in organizations that value team building and information sharing.

Controlling

Learning Outcome

1. Describe the process by which a manager monitors operations and assesses performance.

Let's pause for a minute and reflect on the management functions that we've discussed so far—planning, organizing, and directing. As founder of Notes-4-You, you began by establishing plans for your new company. You defined its mission and set objectives, or performance targets, which you needed to meet in order to achieve your mission. Then, you organized your company by allocating the people and resources required to carry out your plans. Finally, you provided focus and direction to your employees and motivated them to achieve organizational objectives. Is your job finished? Can you take a well-earned vacation? Unfortunately, the answer is no: your work has just begun. Now that things are rolling along, you need to monitor your operations to see whether everything is going according to plan. If it's not, you'll need to take corrective action. This process of comparing actual to planned performance and taking necessary corrective action is called controlling.

A Five-Step Control Process

You can think of the control function as the five-step process outlined in Figure 7 "Five-Step Control Process."

Let's see how this process might work at Notes-4-You. Let's assume that, after evaluating class enrollments, you estimate that you can sell one hundred notes packages per month

to students taking the sophomore-level geology course popularly known as “Rocks for Jocks.” So you set your standard at a hundred units. At the end of the month, however, you look over your records and find that you sold only eighty. Comparing your actual performance with your planned performance, you realize that you came up twenty packages short. In talking with your salespeople, you learn why: it turns out that the copy machine broke down so often that packages frequently weren’t ready on time. You immediately take corrective action by increasing maintenance on the copy machine.



Figure 36 Five-Step Control Process

Now, let’s try a slightly different scenario. Let’s say that you still have the same standard (one hundred packages) and that actual sales are still eighty packages. In investigating the reason for the shortfall, you find that you overestimated the number of students taking “Rocks for Jocks.” Calculating a more accurate number of students, you see that your original standard—estimated sales—was too high by twenty packages. In this case, you should adjust your standards to reflect expected sales of eighty packages.

In both situations, your control process has been helpful. In the first instance, you were alerted to a problem that cut into your sales. Correcting this problem would undoubtedly increase sales and, therefore, profits. In the second case, you encountered a defect in your planning and learned a good managerial lesson: plan more carefully.

Key Takeaways

- The process of comparing actual to planned performance and taking corrective action is called **controlling**.

- The control function can be viewed as a five-step process:
 1. Establish standards
 2. Measure performance
 3. Compare actual performance with standards and identify any deviations
 4. Determine the reason for deviations
 5. Take corrective action if needed.

Managerial Skills

Learning Objective

1. Describe the skills needed to be a successful manager.

To be a successful manager, you'll have to master a number of skills. To get an entry-level position, you'll have to be technically competent at the tasks you're asked to perform. To advance, you'll need to develop strong interpersonal and conceptual skills. The relative importance of different skills varies from job to job and organization to organization, but to some extent, you'll need them all to forge a managerial career. Throughout your career, you'll also be expected to communicate ideas clearly, use your time efficiently, and reach sound decisions.

Technical Skills

You'll probably be hired for your first job based on your technical skills—the ones you need to perform specific tasks—and you'll use them extensively during your early career. If your college major is accounting, you'll use what you've learned to prepare financial statements. If you have a marketing degree and you join an ad agency, you'll use what you know about promotion to prepare ad campaigns. Technical skills will come in handy when you move up to a first-line managerial job and oversee the task performance of subordinates. Technical skills, though developed through job training and work experience, are generally acquired during the course of your formal education.

Interpersonal Skills

As you move up the corporate ladder, you'll find that you can't do everything yourself: you'll have to rely on other people to help you achieve the goals for which you're

responsible. That’s why interpersonal skills—the ability to get along with and motivate other people—are critical for managers in mid-level positions. These managers play a pivotal role because they report to top-level managers while overseeing the activities of first-line managers. Thus, they need strong working relationships with individuals at all levels and in all areas. More than most other managers, they must use “people skills” to foster teamwork, build trust, manage conflict, and encourage improvement.¹⁵⁹

Conceptual Skills

Managers at the top, who are responsible for deciding what’s good for the organization from the broadest perspective, rely on conceptual skills—the ability to reason abstractly and analyze complex situations. Senior executives are often called on to “think outside the box”—to arrive at creative solutions to complex, sometimes ambiguous problems. They need both strong analytical abilities and strong creative talents.

Communication Skills

Effective communication skills are crucial to just about everyone. At all levels of an organization, you’ll often be judged on your ability to communicate, both orally and in writing. Whether you’re talking informally or making a formal presentation, you must express yourself clearly and concisely. Talking too loudly, rambling, and using poor grammar reduce your ability to influence others, as does poor written communication. Confusing and error-riddled documents (including e-mails) don’t do your message any good, and they will reflect poorly on you.¹⁶⁰

Time-Management Skills

Managers face multiple demands on their time, and their days are usually filled with interruptions. Ironically, some technologies that were supposed to save time, such as voicemail and e-mail, have actually increased workloads. Unless you develop certain time-management skills, you risk reaching the end of the day feeling that you’ve worked a lot but accomplished little. What can managers do to ease the burden? Here are a few common-sense suggestions:

- Prioritize tasks, focusing on the most important things first.
- Set aside a certain time each day to return phone calls and answer e-mail.
- Delegate routine tasks.

- Don't procrastinate.
- Insist that meetings start and end on time, and stick to an agenda.
- Eliminate unnecessary paperwork.¹⁶¹

Decision-Making Skills

Every manager is expected to make decisions, whether alone or as part of a team.

Drawing on your decision-making skills is often a process in which you must define a problem, analyze possible solutions, and select the best outcome. As luck would have it, because the same process is good for making personal decisions, we'll use a personal example to demonstrate the process approach to decision making. Consider the following scenario: You're upset because your midterm grades are much lower than you'd hoped. To make matters worse, not only are you in trouble academically, but also the other members of your business-project team are annoyed because you're not pulling your weight. Your lacrosse coach is very upset because you've missed too many practices, and members of the mountain-biking club of which you're supposed to be president are talking about impeaching you if you don't show up at the next meeting. And your girlfriend says you're ignoring her. (You can substitute "boyfriend" here, of course; we're just trying to keep our exposition as simple as possible.)

A Six-Step Approach to Problem Solving

Assuming that your top priority is salvaging your GPA, let's tackle your problem by using a six-step approach to solving problems that don't have simple solutions. We've summarized this model in Figure 8 "How to Solve a Problem".¹⁶²

- *Identify the problem you want to work on.* Step one is getting to know your problem, which you can formulate by asking yourself a basic question: How can I improve my grades?

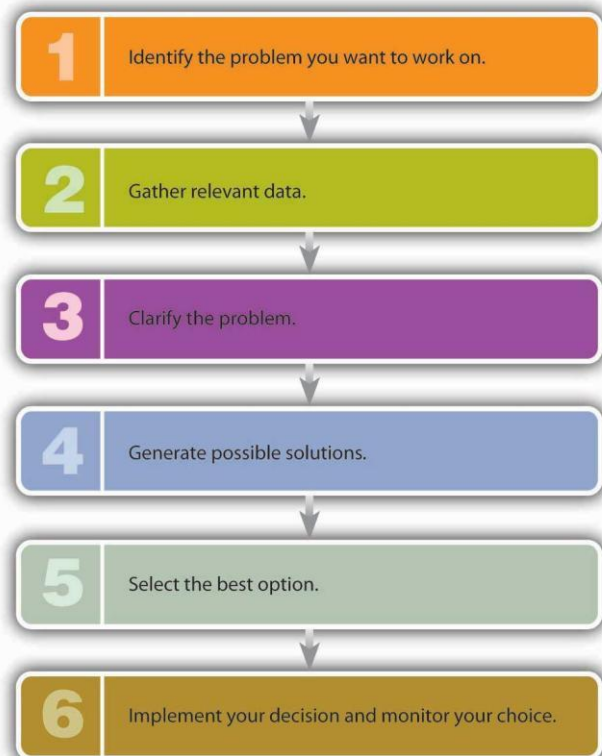


Figure 37 How to Solve a Problem

- *Gather relevant data.* Step two is gathering information that will shed light on the problem. Let's rehash some of the relevant information that you've already identified:
 1. You did poorly on your finals because you didn't spend enough time studying.
 2. You didn't study because you went to see your girlfriend (who lives about three hours from campus) over the weekend before your exams (and on most other weekends, as a matter of fact).
 3. What little studying you got in came at the expense of your team project and lacrosse practice.
 4. While you were away for the weekend, you forgot to tell members of the mountain-biking club that you had to cancel the planned meeting.
- *Clarify the problem.* Once you review all the given facts, you should see that your problem is bigger than simply getting your grades up; your life is pretty much out of control. You can't handle everything to which you've committed yourself. Something has to give. You clarify the problem by summing it up with another basic question: What can I do to get my life back in order?
- *Generate possible solutions.* If you thought defining the problem was tough, wait until you've moved on to this stage. Let's say that you've come up with the following possible solutions to your problem:
 1. Quit the lacrosse team.
 2. Step down as president of the mountain-biking club.
 3. Let team members do your share of work on the business project.
 4. Stop visiting your girlfriend so frequently. The solution to your main problem—how to get your life back in order—will probably require multiple actions.
- *Select the best option.* This is clearly the toughest part of the process. Working your way through your various options, you arrive at the following conclusions:
 1. You can't quit the lacrosse team because you'd lose your scholarship.
 2. You can resign your post in the mountain-biking club, but that won't free up much time.

3. You can't let your business-project team down (and besides, you'd just get a low grade).
 4. She wouldn't like the idea, but you could visit your girlfriend, say, once a month rather than once a week. So what's the most feasible (if not necessarily perfect) solution? Probably visiting your girlfriend once a month and giving up the presidency of the mountain-biking club.
- *Implement your decision and monitor your choice.* When you call your girlfriend, you're pleasantly surprised to find that she understands. The vice president is happy to take over the mountain-biking club. After the first week, you're able to attend lacrosse practice, get caught up on your team business project, and catch up in all your other classes. The real test of your solution will be the results of the semester's finals.

Applying Your Skills at Notes-4-You

So, what types of skills will managers at Notes-4-You need? To oversee note-taking and copying operations, first-line managers will require technical skills, probably in operations and perhaps in accounting. Middle managers will need strong interpersonal skills to maintain positive working relationships with subordinates and to motivate them. As president, because you have to solve problems and come up with creative ways to keep the business growing, you'll need conceptual skills. And everyone will have to communicate effectively: after all, because you're in the business of selling written notes, it would look pretty bad if your employees wrote poorly. Finally, everyone will have to use time efficiently and call on problem-solving skills to handle the day-to-day crises that seem to plague every new company.

Key Takeaways

- The skills needed by managers vary according to level.
- Top managers need strong **conceptual skills**, while those at midlevel need good **interpersonal skills** and those at lower levels need **technical skills**.
- All managers need strong **communication, decision-making, and time-management skills**.

Chapter 6 Review Questions

Multiple Choice:

- This function of management involves providing focus for employees and motivating them to achieve organizational goals.
 1. Planning
 2. Organizing
 3. Directing
 4. Controlling
- This is a simple, concise statement that describes the purpose of the organization.
 1. Strategic plan
 2. Mission statement
 3. Core values
 4. SWOT analysis
- This plan specifies the activities and allocation of resources.
 1. Tactical plan
 2. Operational plan
 3. Contingency plan
- Division by _____ involves organizing people into smaller, self-contained units, or divisions, which are accountable for their own performance.
 1. Functional
 2. Divisional
 3. Geographical
- _____ managers mentor and develop subordinates and motivate them to achieve organizational goals.
 1. Transactional
 2. Democratic
 3. Laissez-faire
 4. Transformational

Short Answer:

1. What are the four areas of tasks that management performs?
2. What are the three levels of management within organizing?
3. What are the five steps in the control process?

Chapter 7 Recruiting, Motivating, and Keeping Quality Employees

Human Resource Management

Learning Objective

1. Define human resource management and explain how managers develop and implement a human resource plan.

Employees at Starbucks are vital to the company's success. They are its public face, and every dollar of sales passes through their hands.¹⁶³ According to Howard Schultz, they can make or break the company. If a customer has a positive interaction with an employee, the customer will come back. If an encounter is negative, the customer is probably gone for good. That's why it's crucial for Starbucks to recruit and hire the right people, train them properly, motivate them to do their best, and encourage them to stay with the company. Thus, the company works to provide satisfying jobs, a positive work environment, appropriate work schedules, and fair compensation and benefits. These activities are part of Starbucks's strategy to deploy human resources in order to gain competitive advantage. The process is called human resource management (HRM), which consists of all actions that an organization takes to attract, develop, and retain quality employees. Each of these activities is complex. Attracting talented employees involves the recruitment of qualified candidates and the selection of those who best fit the organization's needs. Development encompasses both new-employee orientation and the training and development of current workers. Retaining good employees means motivating them to excel, appraising their performance, compensating them appropriately, and doing what's possible to retain them.

Human Resource Planning

How does Starbucks make sure that its worldwide retail locations are staffed with just the right number of committed employees? How does Walt Disney World ensure that it has

enough qualified “cast members” to provide visitors with a “magical” experience? How does Norwegian Cruise Lines make certain that when the *Norwegian Dawn* pulls out of New York harbor, it has a complete, fully trained crew on board to feed, entertain, and care for its passengers? Managing these tasks is a matter of strategic human resource planning—the process of developing a plan for satisfying an organization’s human resources (HR) needs.

A strategic HR plan lays out the steps that an organization will take to ensure that it has the right number of employees with the right skills in the right places at the right times. HR managers begin by analyzing the company’s mission, objectives, and strategies.

Starbucks’s objectives, for example, include the desire to “develop enthusiastically satisfied customers”¹⁶⁴ as well as to foster an environment in which employees treat both customers and each other with respect. Thus, the firm’s HR managers look for people who are “adaptable, self-motivated, passionate, creative team members.”¹⁶⁵ Likewise, Disney’s overall objectives include not only making all visitors feel as if they’re special in a special place but also ensuring that employees’ appearance reflects a special image (there’s even a forty-seven-page book on the subject).¹⁶⁶ Disney looks for people who best fulfill these job requirements. The main goal of Norwegian Cruise Lines—to lavish passengers with personal attention—determines not only the type of employee desired (one with exceptionally good customer-relation skills and a strong work ethic) but also the number needed (one for every two passengers on the *Norwegian Dawn*).¹⁶⁷

Job Analysis

To develop an HR plan, HR managers must obviously be knowledgeable about the jobs that the organization needs performed. They organize information about a given job by performing a job analysis to identify the tasks, responsibilities, and skills that it entails, as well as the knowledge and abilities needed to perform it. Managers also use the information collected for the job analysis to prepare two documents:

1. A job description, which lists the duties and responsibilities of a position
2. A job specification, which lists the qualifications—skills, knowledge, and abilities—needed to perform the job

HR Supply and Demand Forecasting

Once they've analyzed the jobs within the organization, HR managers must forecast future hiring (or firing) needs. This is the three-step process summarized in Figure 1 "How to Forecast Hiring (and Firing) Needs".



Figure 38 How to Forecast Hiring (and Firing) Needs

Starbucks, for instance, might find that it needs three hundred new employees to work at stores scheduled to open in the next few months. Disney might determine that it needs two thousand new cast members to handle an anticipated surge in visitors. The *Norwegian Dawn* might be short two dozen restaurant workers because of an unexpected

increase in reservations.

After calculating the disparity between supply and future demand, HR managers must draw up plans for bringing the two numbers into balance. If the demand for labor is going to outstrip the supply, they may hire more workers, encourage current workers to put in extra hours, subcontract work to other suppliers, or introduce labor-saving initiatives. If the supply is greater than the demand, they may deal with overstaffing by not replacing workers who leave, encouraging early retirements, laying off workers, or (as a last resort) firing workers.

Recruiting Qualified Employees

Armed with information on the number of new employees to be hired and the types of positions to be filled, the HR manager then develops a strategy for recruiting potential employees. Recruiting is the process of identifying suitable candidates and encouraging them to apply for openings in the organization.

Before going any further, we should point out that, in recruiting and hiring, managers must comply with antidiscrimination laws; violations can have legal consequences.

Discrimination occurs when a person is treated unfairly on the basis of a characteristic unrelated to ability. Under federal law, it's illegal to discriminate in recruiting and hiring on the basis of race, color, religion, sex, national origin, age, or disability. (The same rules apply to other employment activities, such as promoting, compensating, and firing.)¹⁶⁸ The Equal Employment Opportunity Commission (EEOC) enforces a number of federal employment laws, including the following:

- Title VII of the Civil Rights Act of 1964, which prohibits employment discrimination based on race, color, religion, sex, or national origin. Sexual harassment is also a violation of Title VII.
- The Equal Pay Act of 1963, which protects both women and men who do substantially equal work from sex-based pay discrimination.
- The Age Discrimination in Employment Act of 1964, which protects individuals who are forty or older.
- Title I and Title V of the Americans with Disabilities Act of 1990, which prohibits employment discrimination against individuals with disabilities.¹⁶⁹

Where to Find Candidates

The first step in recruiting is to find qualified candidates. Where do you look for them, and how do you decide whether they're qualified? Let's start with the second part of the question first. A qualified person must be able to perform the duties listed in the job description and must possess the skills, knowledge, and abilities detailed in the job specification. In addition, he or she must be a good "fit" for the company. A Disney recruiter, for example, wants a candidate who fits a certain image—someone who's clean-cut and "wholesome" looking. The same recruiter might also favor candidates with certain qualities—someone who has a "good attitude," who's a "go-getter" and a "team player," and who's smart, responsible, and stable.¹⁷⁰

Internal versus External Recruiting

Where do you find people who satisfy so many criteria? Basically, you can look in two places: inside and outside your own organization. Both options have pluses and minuses. Hiring internally sends a positive signal to employees that they can move up in the company—a strong motivation tool and a reward for good performance. In addition,

because an internal candidate is a known quantity, it's easier to predict his or her success in a new position. Finally, it's cheaper to recruit internally. On the other hand, you'll probably have to fill the promoted employee's position. Going outside gives you an opportunity to bring fresh ideas and skills into the company. In any case, it's often the only alternative, especially if no one inside the company has just the right combination of skills and experiences. Entry-level jobs usually have to be filled from the outside.

How to Find Candidates

Whether you search inside or outside the organization, you need to publicize the opening. If you're looking internally in a small organization, you can alert employees informally. In larger organizations, HR managers generally post openings on bulletin boards (often online) or announce them in newsletters. They can also seek direct recommendations from various supervisors.

Recruiting people from outside is more complicated. It's a lot like marketing a product to buyers: in effect, you're marketing the virtues of working for your company. Starbucks uses the following outlets to advertise openings: A dedicated section of the corporate Web site ("Job Center," which lists openings, provides information about the Starbucks experience, and facilitates the submission of online applications)

- College campus recruiting (holding on-campus interviews and information sessions and participating in career fairs)
- Internships designed to identify future talent among college students
- Announcements on employment Web sites like [Monster.com](http://www.monster.com), [Vault.com](http://www.vault.com), [Glassdoor.com](http://www.glassdoor.com), and [SimplyHired.com](http://www.simplyhired.com)
- Newspaper classified ads
- Facebook and Twitter
- Local job fairs
- In-store recruiting posters
- Informative "business cards" for distribution to customers.¹⁷¹

When asked what it takes to attract the best people, Starbucks's senior executive Dave Olsen replied, "Everything matters." Everything Starbucks does as a company bears on its

ability to attract talent. Accordingly, everyone is responsible for recruiting, not just HR specialists. In fact, the best source of quality applicants is the company's own labor force.¹⁷²

The Selection Process

Recruiting gets people to apply for positions, but once you've received applications, you still have to select the best candidate—another complicated process.

The selection process entails gathering information on candidates, evaluating their qualifications, and choosing the right one. At the very least, the process can be time-consuming—particularly when you're filling a high-level position—and often involves several members of an organization.

Let's examine the selection process more closely by describing the steps that you'd take to become a special agent for the Federal Bureau of Investigation (FBI).¹⁷³ Most business students don't generally aspire to become FBI agents, but the FBI is quite interested in business graduates—especially if you have a major in accounting or finance. With one of these backgrounds, you'll be given priority in hiring. Why? Unfortunately, there's a lot of white-collar crime that needs to be investigated, and people who know how to follow the money are well suited for the task.

Application

The first step in becoming a gun-toting accountant is, obviously, applying for the job. Don't bother unless you meet the minimum qualifications: you must be a U.S. citizen, be age twenty-three to thirty-seven, be physically fit, and have a bachelor's degree. To provide factual information on your education and work background, you'll submit an application, which the FBI will use as an initial screening tool.

Employment Tests

Next comes a battery of tests (a lot more than you'd take in applying for an everyday business position). Like most organizations, the FBI tests candidates on the skills and knowledge entailed by the job. Unlike most businesses, however, the FBI will also measure your aptitude, evaluate your personality, and assess your writing ability. You'll have to take a polygraph (lie-detector) test to determine the truthfulness of the information

you've provided, uncover the extent of any drug use, and disclose potential security problems.

Interview

If you pass all these tests (with sufficiently high marks), you'll be granted an interview. It serves the same purpose as it does for business recruiters: it allows the FBI to learn more about you and gives you a chance to learn more about your prospective employer and your possible future in the organization. The FBI conducts *structured interviews*—a series of standard questions. You're judged on both your answers and your ability to communicate orally.

Physical Exam and Reference Checks

Let's be positive and say you passed the interview. What's next? You still have to pass a rigorous physical examination (including a drug test), as well as background and reference checks. Given its mission, the FBI sets all these hurdles a little higher than the average retail clothing chain. Most businesses will ask you to take a physical exam, but you probably won't have to meet the fitness standards set by the FBI. Likewise, many businesses check references to verify that applicants haven't lied about (or exaggerated) their education and work experience. The FBI goes to great lengths to ensure that candidates are suitable for law-enforcement work.

Final Decision

The last stage in the process is out of your control. Will you be hired or rejected? This decision is made by one or more people who work for the prospective employer. For a business, the decision maker is generally the line manager who oversees the position being filled. At the FBI, the decision is made by a team at FBI headquarters. If you're hired as a special agent, you'll spend twenty-one weeks of intensive training at the FBI Academy in Quantico, Virginia.

Contingent Workers

Though most people hold permanent, full-time positions, there's a growing number of individuals who work at temporary or part-time jobs. Many of these are contingent workers hired to supplement a company's permanent workforce. Most of them are independent contractors, consultants, or freelancers who are paid by the firms that hire them. Others

are *on-call workers* who work only when needed, such as substitute teachers. Still others are *temporary workers* (or “temps”) who are employed and paid by outside agencies or contract firms that charge fees to client companies.

The Positives and Negatives of Temp Work

The use of contingent workers provides companies with a number of benefits. Because they can be hired and fired easily, employers can better control labor costs. When things are busy, they can add temps, and when business is slow, they can release unneeded workers. Temps are often cheaper than permanent workers, particularly because they rarely receive costly benefits. Employers can also bring in people with specialized skills and talents to work on special projects without entering into long-term employment relationships. Finally, companies can “try out” temps: if someone does well, the company can offer permanent employment; if the fit is less than perfect, the employer can easily terminate the relationship. There are downsides to the use of contingent workers, including increased training costs and decreased loyalty to the company. Also, many employers believe that because temps are usually less committed to company goals than permanent workers, productivity suffers.

What about you? Does temporary work appeal to you? On the plus side, you can move around to various companies and gain a variety of skills. You can see a company from the inside and decide up front whether it’s the kind of place you’d like to work at permanently. If it is, your temporary position lets you showcase your skills and talents and grab the attention of management, which could increase the likelihood you’ll be offered a permanent position. There are also some attractive lifestyle benefits. You might, for example, work at a job or series of jobs for, say, ten months and head for the beach for the other two. On the other hand, you’ll probably get paid less, receive no benefits, and have no job security. For most people, the idea of spending two months a year on the beach isn’t *that* appealing.

Key Takeaways

- The process of **human resource management** consists of all the actions that an organization takes to attract, develop, and retain quality employees.
- To ensure that the organization is properly staffed, managers engage in **strategic human resource planning**—the process of developing a plan for satisfying the organization’s human resource needs.
- Managers organize information about a given job by performing a **job analysis**, which they use to prepare two documents: a **job description** listing the duties and responsibilities of a position and a **job specification**, which lists the qualifications— skills, knowledge, and abilities—needed to perform the job.
- After analyzing the jobs that must be performed, the HR manager forecasts future hiring needs and begins the **recruiting** process to identify suitable candidates and encourage them to apply.
- In recruiting and hiring, managers must comply with antidiscrimination laws enforced by the **Equal Employment Opportunity Commission (EEOC)**.
- **Discrimination** occurs when a person is treated unfairly on the basis of a characteristic unrelated to ability, such as race, color, religion, sex, national origin, age, or disability.
- Once a pool of suitable candidates has been identified, managers begin the **selection** process, reviewing information provided by candidates on employment **applications** and administering tests to assess candidates’ skills and knowledge.
- Candidates who pass this stage may be granted an **interview** and, perhaps, offered a job.

Motivating Employees

Learning Objective

1. Define motivation and describe several theories of motivation.

Motivation refers to an internally generated drive to achieve a goal or follow a particular course of action. Highly motivated employees focus their efforts on achieving specific

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goals; those who are unmotivated don't. It's the manager's job, therefore, to motivate employees—to get them to try to do the best job they can. But what motivates employees to do well? How does a manager encourage employees to show up for work each day and do a good job? Paying them helps, but many other factors influence a person's desire (or lack of it) to excel in the workplace. What are these factors? Are they the same for everybody? Do they change over time? To address these questions, we'll examine four of the most influential theories of motivation: *hierarchy-of-needs theory*, *two-factor theory*, *expectancy theory*, and *equity theory*.

Hierarchy-of-Needs Theory

Psychologist Abraham

Maslow's hierarchy-of-needs theory proposed that we are motivated by the five unmet needs, arranged in the hierarchical order shown in Figure 2 "Maslow's Hierarchy-of-Needs Theory", which also lists examples of each type of need in both the personal and work spheres of life. Look, for instance, at the list of personal needs in the left-hand column.

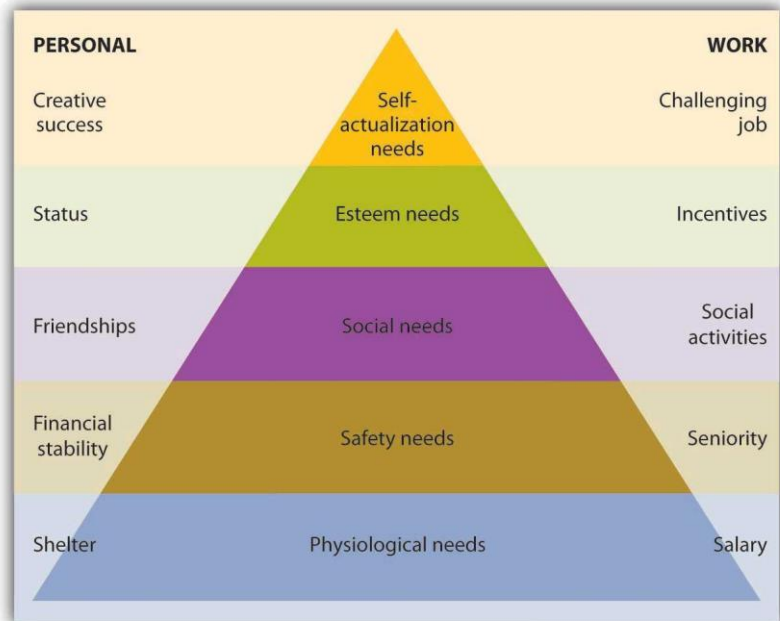


Figure 39 Maslow's Hierarchy-of-Needs Theory

At the bottom are *physiological* needs (such life-sustaining needs as food and shelter). Working up the hierarchy we experience *safety* needs (financial stability, freedom from physical harm), *social* needs (the need to belong and have friends), *esteem* needs (the need for self-respect and status), and *self-actualization* needs (the need to reach one's full potential or achieve some creative success).

There are two things to remember about Maslow's model:

1. We must satisfy lower-level needs before we seek to satisfy higher-level needs.

2. Once we've satisfied a need, it no longer motivates us; the next higher need takes its place.

Let's say, for example, that you've just returned to college and that for a variety of reasons that aren't your fault, you're broke, hungry, and homeless. Because you'll probably take almost any job that will pay for food and housing (*physiological* needs), you go to work repossessing cars. Fortunately, your student loan finally comes through, and with enough money to feed yourself, you can look for a job that's not so risky (a *safety* need). You find a job as a night janitor in the library, and though you feel secure, you start to feel cut off from your friends, who are active during daylight hours. You want to work among people, not books (a *social* need). So now you join several of your friends selling pizza in the student center. This job improves your social life, but even though you're very good at making pizzas, it's not terribly satisfying. You'd like something that will let you display your intellectual talents (an *esteem* need). So you study hard and land a job as an intern in the governor's office. On graduation, you move up through a series of government appointments and eventually run for state senator. As you're sworn into office, you realize that you've reached your full potential (a *self-actualization* need) and you comment to yourself, "It doesn't get any better than this."

Needs Theory and the Workplace

What implications does Maslow's theory have for business managers? There are two key points: (1) Not all employees are driven by the same needs, and (2) the needs that motivate individuals can change over time. Managers should consider which needs different employees are trying to satisfy and should structure rewards and other forms of recognition accordingly. For example, when you got your first job repossessing cars, you were motivated by the need for money to buy food. If you'd been given a choice between a raise or a plaque recognizing your accomplishments, you'd undoubtedly have opted for the money. As a state senator, by contrast, you may prefer public recognition of work well done (say, election to higher office) to a pay raise.

Two-Factor Theory

Another psychologist, Frederick Herzberg, set out to determine which work factors (such as wages, job security, or advancement) made people feel good about their jobs and

which factors made them feel bad about their jobs. He surveyed workers, analyzed the results, and concluded that to understand employee *satisfaction* (or *dissatisfaction*), he had to divide work factors into two categories:

- *Motivation factors*. Those factors that are strong contributors to job satisfaction
- *Hygiene factors*. Those factors that are *not* strong contributors to satisfaction but that must be present to meet a worker’s expectations and prevent job dissatisfaction

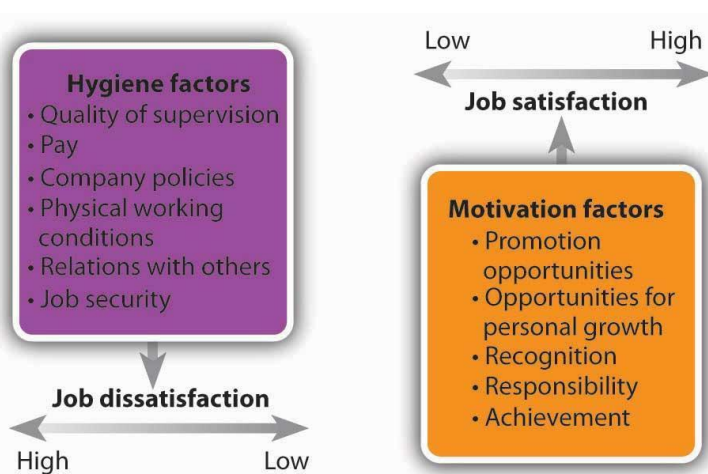


Figure 40 Herzberg’s Two-Factor Theory

Figure 3 "Herzberg’s Two-Factor Theory" illustrates Herzberg’s two-factor theory. Note that motivation factors (such as promotion opportunities) relate to *the nature of the work itself and the way the employee performs it*. Hygiene factors (such as physical working conditions) relate to *the environment in which it’s performed*.

(Note, too, the similarity between Herzberg’s motivation factors and Maslow’s esteem and self-actualization needs.)

Two-Factor Theory and the Workplace

We’ll ask the same question about Herzberg’s model as we did about Maslow’s: What does it mean for managers? Suppose you’re a senior manager in an accounting firm, where you supervise a team of accountants, each of whom has been with the firm for five years. How would you use Herzberg’s model to motivate the employees who report to you? Let’s start with hygiene factors. Are salaries reasonable? What about working conditions? Does each accountant have his or her own workspace, or are they crammed into tiny workrooms? Are they being properly supervised or are they left on their own to sink or swim? If hygiene factors like these don’t meet employees’ expectations, they may be dissatisfied with their jobs.

As you can see in Figure 3 "Herzberg's Two-Factor Theory", fixing problems related to hygiene factors may alleviate job *dissatisfaction*, but it won't necessarily improve anyone's job *satisfaction*. To increase satisfaction (and motivate someone to perform better), you must address motivation factors. Is the work itself challenging and stimulating? Do employees receive recognition for jobs well done? Will the work that an accountant has been assigned help him or her to advance in the firm? According to Herzberg, motivation requires a twofold approach: eliminating dissatisfiers and enhancing satisfiers.

Expectancy Theory

If you were a manager, wouldn't you like to know how your employees decide to work hard or goof off? Wouldn't it be nice to know whether a planned rewards program will have the desired effect—namely,

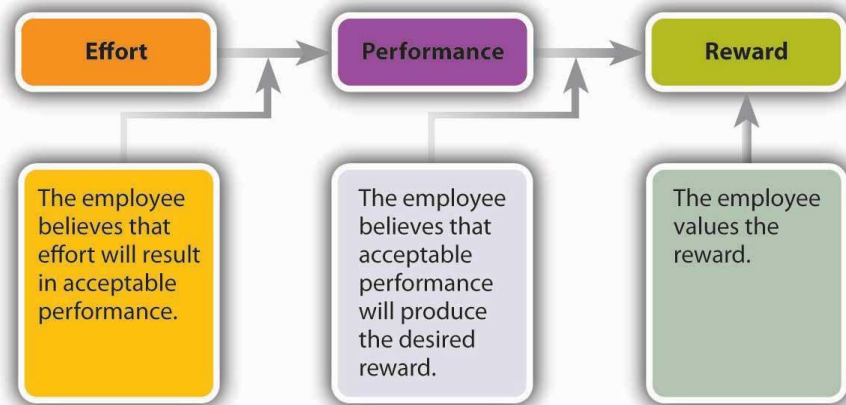


Figure 41 Vroom's Expectancy Theory

motivating them to

perform better in their jobs? Wouldn't it be helpful if you could measure the effect of bonuses on employee productivity? These are the issues considered by psychologist Victor Vroom in his expectancy theory, which proposes that employees will work hard to earn rewards that they value and that they consider obtainable.

As you can see from Figure 4 "Vroom's Expectancy Theory", Vroom argues that an employee will be motivated to exert a high level of effort to obtain a reward under three conditions:

1. The employee believes that his or her efforts will result in acceptable performance.
2. The employee believes that acceptable performance will lead to the desired outcome or reward.
3. The employee values the reward.

Expectancy Theory and the Workplace

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To apply expectancy theory to a real-world situation, let's analyze an automobile-insurance company with one hundred agents who work from a call center. Assume that the firm pays a base salary of \$2,000 a month, plus a \$200 commission on each policy sold above ten policies a month. In terms of expectancy theory, under what conditions would an agent be motivated to sell more than ten policies a month?

1. The agent would have to believe that his or her efforts would result in policy sales (that, in other words, there's a positive link between effort and performance).
2. The agent would have to be confident that if he or she sold more than ten policies in a given month, there would indeed be a bonus (a positive link between performance and reward).
3. The bonus per policy—\$200—would have to be of value to the agent.

Now let's alter the scenario slightly. Say that the company raises prices, thus making it harder to sell the policies. How will agents' motivation be affected? According to expectancy theory, motivation will suffer. Why? Because agents may be less confident that their efforts will lead to satisfactory performance. What if the company introduces a policy whereby agents get bonuses only if buyers don't cancel policies within ninety days? How will this policy affect motivation? Now agents may be less confident that they'll get bonuses even if they do sell more than ten policies. Motivation will decrease because the link between performance and reward has been weakened. Finally, what will happen if bonuses are cut from \$200 to \$25? Obviously, the reward would be of less value to agents, and, again, motivation will suffer. The message of expectancy theory, then, is fairly clear: managers should offer rewards that employee's value, set performance levels that they can reach, and ensure a strong link between performance and reward.

Equity Theory

What if you spent thirty hours working on a class report, did everything you were supposed to do, and handed in an excellent assignment (in your opinion). Your roommate, on the other hand, spent about five hours and put everything together at the last minute. You know, moreover, that he ignored half the requirements and never even ran his assignment through a spell-checker. A week later, your teacher returns the reports. You get a C and your roommate gets a B+. In all likelihood, you'll feel that you've been treated unfairly

relative to your roommate.

Your reaction makes sense according to the equity theory of motivation, which focuses on our perceptions of how fairly we're treated *relative to others*. Applied to the work environment, this theory proposes that employees analyze their contributions or job inputs (hours worked, education, experience, work performance) and their rewards or job outcomes (salary, benefits, recognition). Then they create a contributions/rewards ratio and compare it to those of other people. The basis of comparison can be any one of the following:

- Someone in a similar *position*
- Someone holding a different position in the same *organization*
- Someone with a similar *occupation*
- Someone who shares certain *characteristics* (such as age, education, or level of experience)
- Oneself at another point in time

When individuals perceive that the ratio of their contributions to rewards is comparable to that of others, they perceive that they're being treated equitably; when they perceive that the ratio is out of balance, they perceive inequity. Occasionally, people will perceive that they're being treated better than others. More often, however, they conclude that others are being treated better (and that they themselves are being treated worse). This is what you concluded when you saw your grade. You've calculated your ratio of contributions (hours worked, research and writing skills) to rewards (project grade), compared it to your roommate's ratio, and concluded that the two ratios are out of balance.

What will an employee do if he or she perceives an inequity? The individual might try to bring the ratio into balance, either by decreasing inputs (working fewer hours, refusing to take on additional tasks) or by increasing outputs (asking for a raise). If this strategy fails, an employee might complain to a supervisor, transfer to another job, leave the organization, or rationalize the situation (perhaps deciding that the situation isn't so bad after all). Equity theory advises managers to focus on treating workers fairly, especially in determining compensation, which is, naturally, a common basis of comparison.

Key Takeaways

- **Motivation** describes an internally generated drive that propels people to achieve goals or pursue particular courses of action.
- There are four influential theories of motivation: hierarchy-of-needs theory, two-factor theory, expectancy theory, and equity theory.
 1. **Hierarchy-of-needs theory** proposes that we're motivated by five unmet needs—physiological, safety, social, esteem, and self-actualization—and must satisfy lower-level needs before we seek to satisfy higher-level needs.
 2. **Two-factor theory** divides work factors into motivation factors (those that are strong contributors to job satisfaction) and hygiene factors (those that, though not strong contributors to satisfaction, must be present to prevent job dissatisfaction). To increase satisfaction (and motivate someone to perform better), managers must address motivation factors.

3. **Expectancy theory** proposes that employees work hard to obtain a reward when they value the reward, believe that their efforts will result in acceptable performance, and believe that acceptable performance will lead to a desired outcome or reward.
4. **Equity theory** focuses on our perceptions of how fairly we're treated relative to others. This theory proposes that employees create contributions/rewards ratios that they compare to those of others. If they feel that their ratios are comparable to those of others, they'll perceive that they're being treated equitably.

What Makes a Great Place to Work?

Learning Objective

1. Identify factors that make an organization a good place to work, including competitive compensation and benefits packages.

Every year, the Great Places to Work Institute analyzes comments from thousands of employees and compiles a list of “The 100 Best Companies to Work for in America,” which is published in *Fortune* magazine. Having compiled its list for more than twenty years, the institute concludes that the defining characteristic of a great company to work for is trust between managers and employees. Employees overwhelmingly say that they want to work at a place where employees “trust the people they work for, have pride in what they do, and enjoy the people they work with.”¹⁷⁴ They report that they’re motivated to perform well because they’re challenged, respected, treated fairly, and appreciated. They take pride in what they do, are made to feel that they make a difference, and are given opportunities for advancement.¹⁷⁵ The most effective motivators, it would seem, are closely aligned with Maslow’s higher-level needs and Herzberg’s motivating factors.

Job Redesign

The average employee spends more than two thousand hours a year at work. If the job is tedious, unpleasant, or otherwise unfulfilling, the employee probably won’t be motivated to perform at a very high level. Many companies practice a policy of job redesign to make jobs more interesting and challenging. Common strategies include *job rotation*, *job enlargement*, and *job enrichment*.

Job Rotation

Specialization promotes efficiency because workers get very good at doing particular tasks. The drawback is the tedium of repeating the same task day in and day out. The practice of job rotation allows employees to rotate from one job to another on a systematic basis, eventually cycling back to their original tasks. A computer maker, for example, might rotate a technician into the sales department to increase the employee’s awareness of customer needs and to give the employee a broader understanding of the company’s goals and operations. A hotel might rotate an accounting clerk to the check-in desk for a few hours each day to add variety to the daily workload. Rotated employees develop new skills and gain experience that increases their value to the company, which benefits management because cross-trained employees can fill in for absentees, thus providing greater flexibility in scheduling.

Job Enlargement

Instead of a job in which you performed just one or two tasks, wouldn’t you prefer a job

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that gave you many different tasks? In theory, you'd be less bored and more highly

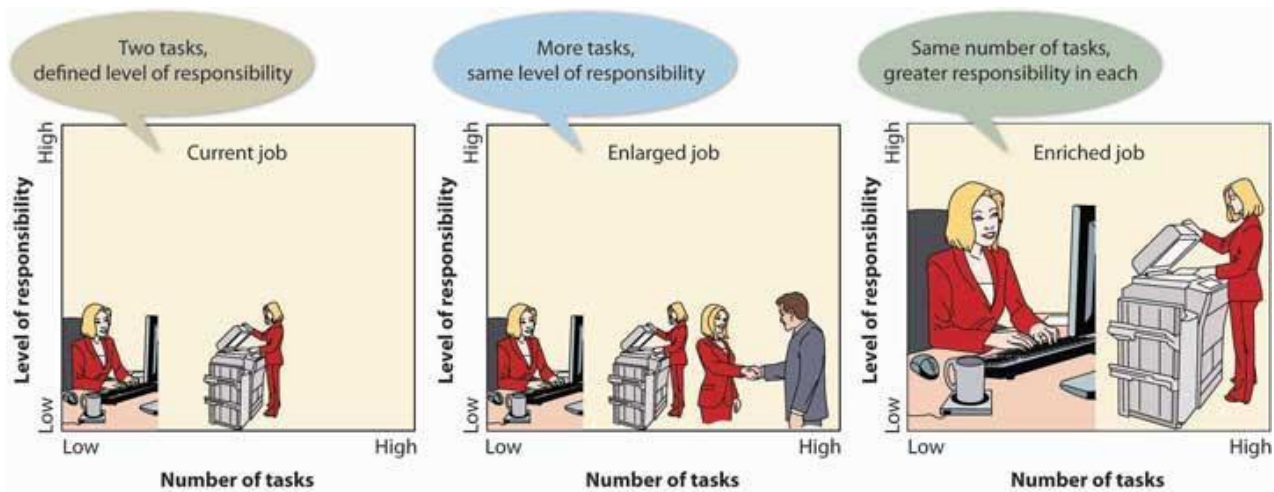


Figure 42 Job Enlargement versus Job Enrichment

motivated if you had a chance at job enlargement—the policy of enhancing a job by adding tasks at similar skill levels (see Figure 5 "Job Enlargement versus Job Enrichment"). The job of sales clerk, for example, might be expanded to include gift-wrapping and packaging items for shipment. The additional duties would add variety without entailing higher skill levels.

Job Enrichment

As you can see from Figure 5 "Job Enlargement versus Job Enrichment", merely expanding a job by adding similar tasks won't necessarily "enrich" it by making it more challenging and rewarding. Job enrichment is the practice of adding tasks that increase both responsibility and opportunity for growth. It provides the kinds of benefits that, according to Maslow and Herzberg, contribute to job satisfaction: stimulating work, sense of personal achievement, self-esteem, recognition, and a chance to reach your potential. Consider, for example, the evolving role of support staff in the contemporary office. Today, employees who used to be called "secretaries" assume many duties previously in the domain of management, such as project coordination and public relations. Information technology has enriched their jobs because they can now apply such skills as word processing, desktop publishing, creating spreadsheets, and managing databases. That's why we now hear such a term as *administrative assistant* instead of *secretary*.¹⁷⁶

Work/Life Quality

Building a career requires a substantial commitment in time and energy, and most people

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find that they aren't left with much time for nonwork activities. Fortunately, many organizations recognize the need to help employees strike a balance between their work and home lives.¹⁷⁷ By helping employees combine satisfying careers and fulfilling personal lives, companies tend to end up with a happier, less-stressed, and more productive workforce. The financial benefits include lower absenteeism, turnover, and health care costs.

Alternative Work Arrangements

The accounting firm KPMG, which has made the list of the “100 Best Companies for Working Mothers” for twelve years,¹⁷⁸ is committed to promoting a balance between its employees' work and personal lives. KPMG offers a variety of work arrangements designed to accommodate different employee needs and provide scheduling flexibility.¹⁷⁹

Flextime

Employers who provide for flextime set guidelines that allow employees to designate starting and quitting times. Guidelines, for example, might specify that all employees must work eight hours a day (with an hour for lunch) and that four of those hours must be between 10 a.m. and 3 p.m. Thus, you could come in at 7 a.m. and leave at 4 p.m., while coworkers arrive at 10 a.m. and leave at 7 p.m. With permission you could even choose to work from 8 a.m. to 2 p.m., take two hours for lunch, and then work from 4 p.m. to 6 p.m.

Compressed Workweeks

Rather than work eight hours a day for five days a week, you might elect to earn a three-day weekend by working ten hours a day for four days a week.

Part-Time Work

If you're willing to have your pay and benefits adjusted accordingly you can work fewer than forty hours a week.

Job Sharing

Under job sharing, two people share one full-time position, splitting the salary and benefits of the position as each handles half the job. Often they arrange their schedules to include at least an hour of shared time during which they can communicate about the job.

Telecommuting

Telecommuting means that you regularly work from home (or from some other non-work location). You're connected to the office by computer, fax, and phone. You save on commuting time, enjoy more flexible work hours, and have more opportunity to spend time with your family. A study of 5,500 IBM employees (one-fifth of whom telecommute) found that those who worked at home not only had a better balance between work and home life but also were more highly motivated and less likely to leave the organization.¹⁸⁰

Though it's hard to count telecommuters accurately, some estimates put the number of people who work at home at least one day a week at 20 percent. This estimate includes 2 percent of workers who run home-based businesses and 2 percent who work exclusively at home for other companies.¹⁸¹ Telecommuting isn't for everyone. Working at home means that you have to discipline yourself to avoid distractions, such as TV, personal phone calls, home chores, or pets, and some people feel isolated from social interaction in the workplace.

Family-Friendly Programs

In addition to alternative work arrangements, many employers, including KPMG, offer programs and benefits designed to help employees meet family and home obligations while maintaining busy careers. KPMG offers each of the following benefits.¹⁸²

Dependent Care

Caring for dependents—young children and elderly parents—is of utmost importance to some employees, but combining dependent-care responsibilities with a busy job can be particularly difficult. KPMG provides on-site child care during tax season (when employees are especially busy) and offers emergency backup dependent care all year round, either at a provider's facility or in the employee's home. To get referrals or information, employees can call KPMG's LifeWorks Resource and Referral Service. KPMG is by no means unique in this respect: more than eight thousand companies maintain on-site day care,¹⁸³ and 18 percent of all U.S. companies offer child-care resources or referral services.¹⁸⁴

Paid Parental Leave

Any employee (whether male or female) who becomes a parent can take two weeks of paid leave. New mothers also get time off through short-term disability benefits.

Caring for Yourself

Like many companies, KPMG allows employees to aggregate all paid days off and use them in any way they want. In other words, instead of getting, say, ten sick days, five personal days, and fifteen vacation days, you get a total of thirty days to use for anything. If you're having personal problems, you can contact the Employee Assistance Program. If staying fit makes you happier and more productive, you can take out a discount membership at one of more than nine thousand health clubs.

Unmarried without Children

You've undoubtedly noticed by now that many programs for balancing work and personal lives target married people, particularly those with children. Single individuals also have trouble striking a satisfactory balance between work and non-work activities, but many single workers feel that they aren't getting equal consideration from employers.¹⁸⁵ They report that they're often expected to work longer hours, travel more, and take on difficult assignments to compensate for married employees with family commitments.

Needless to say, requiring singles to take on additional responsibilities can make it harder for them to balance their work and personal lives. It's harder to plan and keep personal commitments while meeting heavy work responsibilities, and establishing and maintaining social relations is difficult if work schedules are unpredictable or too demanding.

Frustration can lead to increased stress and job dissatisfaction. In several studies of stress in the accounting profession, unmarried workers reported higher levels of stress than any other group, including married people with children.¹⁸⁶

With singles, as with married people, companies can reap substantial benefits from programs that help employees balance their work and non-work lives: they can increase job satisfaction and employee productivity and reduce turnover. PepsiCo, for example, offers a "concierge service," which maintains a dry cleaner, travel agency, convenience store, and fitness center on the premises of its national office in Somers, New York.¹⁸⁷ Single employees seem to find these services helpful, but what they value most of all is control over their time. In particular, they want predictable schedules that allow them to plan social and personal activities. They don't want employers assuming that being single means that they can change plans at the last minute. It's often more difficult for singles to

deal with last-minute changes because, unlike married coworkers, they don't have the at-home support structure to handle such tasks as tending to elderly parents or caring for pets.

Compensation and Benefits

Though paychecks and benefits packages aren't the only reasons why people work, they do matter. Competitive pay and benefits also help organizations attract and retain qualified employees. Companies that pay their employees more than their competitors generally have lower turnover. Consider, for example, The Container Store, which regularly appears on *Fortune* magazine's list of "The 100 Best Companies to Work For."¹⁸⁸ The retail chain staffs its stores with fewer employees than its competitors but pays them more—in some cases, three times the industry average for retail workers. This strategy allows the company to attract extremely talented workers who, moreover, aren't likely to leave the company. Low turnover is particularly valuable in the retail industry because it depends on service-oriented personnel to generate repeat business. In addition to salary and wages, compensation packages often include other financial incentives, such as bonuses and profit-sharing plans, as well as benefits, such as medical insurance, vacation time, sick leave, and retirement accounts.

Wages and Salaries

The largest, and most important, component of a compensation package is the payment of wages or salary. If you're paid according to the number of hours you work, you're earning wages. Counter personnel at McDonald's, for instance, get wages, which are determined by multiplying an employee's hourly wage rate by the number of hours worked during the pay period. On the other hand, if you're paid for fulfilling the responsibilities of a position—regardless of the number of hours required to do it—you're earning a salary. The McDonald's manager gets a salary for overseeing the operations of the restaurant. He or she is expected to work as long as it takes to get the job done, without any adjustment in compensation.

Piecework and Commissions

Sometimes it makes more sense to pay workers according to the quantity of product that they produce or sell. Byrd's Seafood, a crab-processing plant in Crisfield, Maryland, pays workers on piecework: Workers' pay is based on the amount of crabmeat that's picked

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from recently cooked crabs. (A good picker can produce fifteen pounds of crabmeat an hour and earn about \$100 a day.)¹⁸⁹ If you're working on commission, you're probably getting paid for quantity of sales. If you were a sales representative for an insurance company, like The Hartford, you'd get a certain amount of money for each automobile or homeowner policy that you sell.¹⁹⁰

Incentive Programs

In addition to regular paychecks, many people receive financial rewards based on performance, whether their own, their employer's, or both. At computer-chip maker Texas Instruments (TI), for example, employees may be eligible for bonuses, profit sharing, and stock options. All three plans are incentive programs: programs designed to reward employees for good performance.¹⁹¹

Bonus Plans

TI's year-end bonuses—annual income given in addition to salary—are based on company-wide performance. If the company has a profitable year, and if you contributed to that success, you'll get a bonus. If the company doesn't do well, you're out of luck, regardless of what you contributed.

Bonus plans have become quite common, and the range of employees eligible for bonuses has widened in recent years. In the past, bonus plans were usually reserved for managers above a certain level. Today, however, companies have realized the value of extending plans to include employees at virtually every level. The magnitude of bonuses still favors those at the top. High-ranking officers (such as CEOs and CFOs) often get bonuses ranging from 30 percent to 50 percent of their salaries. Upper-level managers may get from 15 percent to 25 percent and middle managers from 10 percent to 15 percent. At lower levels, employees may expect bonuses from 3 percent to 5 percent of their annual compensation.¹⁹²

Profit-Sharing Plans

TI also maintains a profit-sharing plan, which relies on a predetermined formula to distribute a share of the company's profits to eligible employees. Today, about 40 percent of all U.S. companies offer some type of profit-sharing program.¹⁹³ TI's plan, however, is a

little unusual: while most plans don't allow employees to access profit-sharing funds until retirement or termination, TI employees get their shares immediately—in cash.

TI's plan is also pretty generous—as long as the company has a good year. Here's how it works. An employee's profit share depends on the company's operating profit for the year. If profits from operations reach 10 percent of sales, the employee gets a bonus worth 4 percent of his or her salary. If operating profit soars to 20 percent, the employee bonuses go up to 26 percent of salary. But if operating profits fall short of a certain threshold, nobody gets anything.¹⁹⁴

Stock-Option Plans

Like most stock-option plans, the TI plan gives employees the right to buy a specific number of shares of company stock at a set price on a specified date. At TI, an employee may buy stock at its selling price at the time when he or she was given the option. So, if the price of the stock goes up, the employee benefits. Say, for example, that the stock was selling for \$30 a share when the option was granted in 2007. In 2011, it was selling for \$40 a share. Exercising his or her option, the employee could buy TI stock at the 2007 price of \$30 a share—a bargain price.¹⁹⁵ At TI, stock options are used as an incentive to attract and retain top people. Starbucks, by contrast, isn't nearly as selective in awarding stock options. At Starbucks, all employees can earn “Bean Stock”—the Starbucks employee stock-option plan. Both full- and part-time employees get options to buy Starbucks shares at a set price. If the company does well and its stock goes up, employees make a profit. CEO Howard Schultz believes that Bean Stock pays off: because employees are rewarded when the company does well, they have a stronger incentive to add value to the company (and so drive up its stock price). Shortly after the program was begun, the phrase “bean-stocking” became workplace lingo for figuring out how to save the company money.

Benefits

Another major component of an employee's compensation package is benefits—compensation other than salaries, hourly wages, or financial incentives. Types of benefits include the following:

- Legally required benefits (Social Security and Medicare, unemployment insurance, workers' compensation)

- Paid time off (vacations, holidays, sick leave)
- Insurance (health benefits, life insurance, disability insurance)
- Retirement benefits

Unfortunately, the cost of providing benefits is staggering. According to the Employee Benefit Research Institute, it costs an employer 30 percent of a worker's salary to provide the same worker with benefits. If you include pay for time not worked (while on vacation or sick and so on), the percentage increases to 41 percent. So if you're a manager making \$100,000 a year, your employer is also paying out another \$41,000 for your benefits. The most money goes for health care (8 percent of salary costs), paid time off (11 percent), and retirement benefits (5 percent).¹⁹⁶

Some workers receive only benefits required by law, including Social Security, unemployment, and workers' compensation. Low-wage workers generally get only limited benefits and part-timers often nothing at all.¹⁹⁷ Again, Starbucks is generous in offering benefits. The company provides benefits even to the part-timers who make up two-thirds of the company's workforce; anyone working at least twenty hours a week gets medical coverage.

Key Takeaways

- Employees report that they're motivated to perform well when they're challenged, respected, treated fairly, and appreciated.
- Other factors may contribute to employee satisfaction. Some companies use **job redesign** to make jobs more interesting and challenging.
 - **Job rotation** allows employees to rotate from one job to another on a systematic basis.
 - **Job enlargement** enhances a job by adding tasks at similar skill levels.
 - **Job enrichment** adds tasks that increase both responsibility and opportunity for growth.
- Many organizations recognize the need to help employees strike a balance between their work and home lives and offer a variety of work arrangements to accommodate different employee needs.
- **Flextime** allows employees to designate starting and quitting times, compress workweeks, or perform part-time work.

- With **job sharing**, two people share one full-time position.
- **Telecommuting** means working from home. Many employers also offer dependent care, paid leave for new parents, employee-assistance programs, and on-site fitness centers.
- Competitive compensation also helps.
- Workers who are paid by the hour earn **wages**, while those who are paid to fulfill the responsibilities of the job earn **salaries**.
- Some people receive **commissions** based on sales or are paid for output, based on a **piecework** approach.
- In addition to pay, many employees can earn financial rewards based on their own and/or their employer's performance.
- They may receive year-end **bonuses**, participate in **profit-sharing plans** (which use predetermined formulas to distribute a share of company profits among employees), or receive **stock options** (which let them buy shares of company stock at set prices).
- Another component of many compensation packages is **benefits**— compensation other than salaries, wages, or financial incentives. Benefits may include paid time off, insurance, and retirement benefits.

Chapter 7 Review Questions

Multiple Choice:

- Organizing information about a given job by performing _____ to identify the tasks, responsibilities, and skills.
 1. HR planning
 2. Job analysis
 3. HR forecasting
- According to Maslow, this need involves the need for respect and status.
 1. physiological
 2. safety
 3. social,
 4. esteem
- According to Herzberg, _____ are not strong contributors to satisfaction.
 1. Motivation factors
 2. Hygiene factors
 3. Psychological factors
- According to Vroom, the employee must believe that their _____ will be rewarded.
 1. Effort
 2. Performance
 3. Value
- Job _____ makes jobs more interesting and challenging.
 1. redesign
 2. rotation
 3. enlargement
 4. enrichment
- Job _____ adds tasks that increase both responsibility and opportunity for growth.
 1. redesign
 2. rotation
 3. enlargement
 4. enrichment

Short Answer:

1. What are the three steps in strategic HR forecast hiring needs?
2. What are the five levels within Maslow's hierarchy-of-needs theory?
3. Describe the difference between job rotation, enlargement, and enrichment.

Chapter 8 Teamwork and Communications

The Team and the Organization

Learning Objectives

1. Define a team and describe its key characteristics.
2. Explain why organizations use teams and describe different types of teams.

What Is a Team? How Does Teamwork Work?

A team (or a *work team*) is a group of people with complementary skills who work together to achieve a specific goal.¹⁹⁸ In the case of Motorola's RAZR team, the specific goal was to develop (and ultimately bring to market) an ultrathin cell phone that would help restore the company's reputation as a designer of stylistically appealing, high-function phones. The team achieved its goal by integrating specialized but complementary skills in engineering and design and by making the most of its authority to make its own decisions and manage its own operations.

Teams versus Groups

"A group," suggests Bonnie Edelstein, a consultant in organizational development, "is a bunch of people in an elevator. A team is also a bunch of people in an elevator, but the elevator is broken." This distinction may be a little oversimplified, but as our tale of teamwork at Motorola reminds us, a *team* is clearly something more than a mere *group* of individuals. In particular, members of a group—or, more accurately, a *working group*—go about their jobs independently and meet primarily to share information. A group of department-store managers, for example, might meet monthly to discuss their progress in cutting plant costs, but each manager is focused on the goals of his or her department because each is held accountable for meeting only those goals. Teams, by contrast, are responsible for achieving specific common goals, and they're generally empowered to make the decisions needed to complete their authorized tasks.

Some Key Characteristics of Teams

To keep matters in perspective, let's identify five key characteristics of work teams.¹⁹⁹

- *Teams are accountable for achieving specific common goals.* Members are collectively responsible for achieving team goals, and if they succeed, they're rewarded collectively.
- *Teams function interdependently.* Members cannot achieve goals independently and must rely on each other for information, input, and expertise.
- *Teams are stable.* Teams remain intact long enough to finish their assigned tasks, and each member remains on board long enough to get to know every other member.
- *Teams have authority.* Teams possess the decision-making power to pursue their goals and to manage the activities through which they complete their assignments.
- *Teams operate in a social context.* Teams are assembled to do specific work for larger organizations and have the advantage of access to resources available from other areas of their organizations.

Why Organizations Build Teams

Why do major organizations now rely more and more on teams to improve operations?

Executives at Xerox have reported that team-based operations are 30 percent more productive than conventional operations. General Mills says that factories organized around team activities are 40 percent more productive than traditionally organized factories. According to in-house studies at Shenandoah Life Insurance, teams have cut case-handling time from twenty-seven to two days and virtually eliminated service complaints. FedEx says that teams reduced service errors (lost packages, incorrect bills) by 13 percent in the first year.²⁰⁰

Today it seems obvious that teams can address a variety of challenges in the world of corporate activity. Before we go any further, however, we should remind ourselves that data like those we've just cited aren't necessarily definitive. For one thing, they may not be objective—companies are more likely to report successes than failures. As a matter of fact, teams *don't* always work. Indeed, according to one study, team-based projects fail 50 to 70 percent of the time.²⁰¹

The Effect of Teams on Performance

Research shows that companies build and support teams because of their effect on overall workplace performance, both organizational and individual. If we examine the impact of team-based operations according to a wide range of relevant criteria—including product quality, worker satisfaction, and quality of work life, among others—we find that overall organizational performance improves. Table 8.1 "Effect of Teams on Workplace Performance"²⁰² lists several areas in which we can analyze workplace performance and indicates the percentage of companies that have reported improvements in each area.

Table 6 Effect of Teams on Workplace Performance

Area of Performance	Percent of Firms Reporting Improvement
Product and service quality	70
Customer service	67
Worker satisfaction	66
Quality of work life	63
Productivity	61
Competitiveness	50
Profitability	45
Absenteeism/turnover	23

Types of Teams

Teams, then, can improve company and individual performance in a number of areas. Not all teams, however, are formed to achieve the same goals or charged with the same responsibilities. Nor are they organized in the same way. Some, for instance, are more *autonomous* than others—less accountable to those higher up in the organization. Some depend on a team leader who's responsible for defining the team's goals and making sure that its activities are performed effectively. Others are more or less self-governing: though

a leader lays out overall goals and strategies, the team itself chooses and manages the methods by which it pursues its goals and implements its strategies.²⁰³ Teams also vary according to their membership. Let's look at several categories of teams.

Manager-Led Teams

As its name implies, in the manager-led team the manager is the team leader and is in charge of setting team goals, assigning tasks, and monitoring the team's performance. The individual team members have relatively little autonomy. For example, the key employees of a professional football team (a manager-led team) are highly trained (and highly paid) athletes, but their activities on the field are tightly controlled by a head coach. As team manager, the coach is responsible both for developing the strategies by which the team pursues its goal of winning games and for the final outcome of each game (not to mention the season). He's also solely responsible for interacting with managers above him in the organization. The players are responsible only for executing plays.²⁰⁴

Self-Managing Teams

Self-managing teams (also known as *self-directed* or *self-regulating teams*) have considerable autonomy. They are usually small and often absorb activities that were once performed by traditional supervisors. A manager or team leader may determine overall goals, but the members of the self-managing team control the activities needed to achieve the goals, such as planning and scheduling work, sharing tasks, meeting quality standards, and handling day-to-day operations.

Self-managing teams are the organizational hallmark of Whole Foods Market, the largest natural-foods grocer in the United States. Each store is run by ten teams (produce, prepared foods, and so forth), and virtually every store employee is a member of a team. Each team has a designated leader and its own performance targets. (Team leaders also belong to a store team, and store-team leaders belong to a regional team.) To do its job, every team has access to the kind of information—including sales and even salary figures—that most companies reserve for the eyes of traditional managers.²⁰⁵

Needless to say, not every self-managed team enjoys the same degree of autonomy. Companies vary widely in choosing which tasks teams are allowed to manage and which ones are best left to upper-level management only. As you can see in Figure 1 "What

Teams Do (and Don't) Manage", for example, self-managing teams are often allowed to schedule assignments, but they are rarely allowed to fire coworkers.

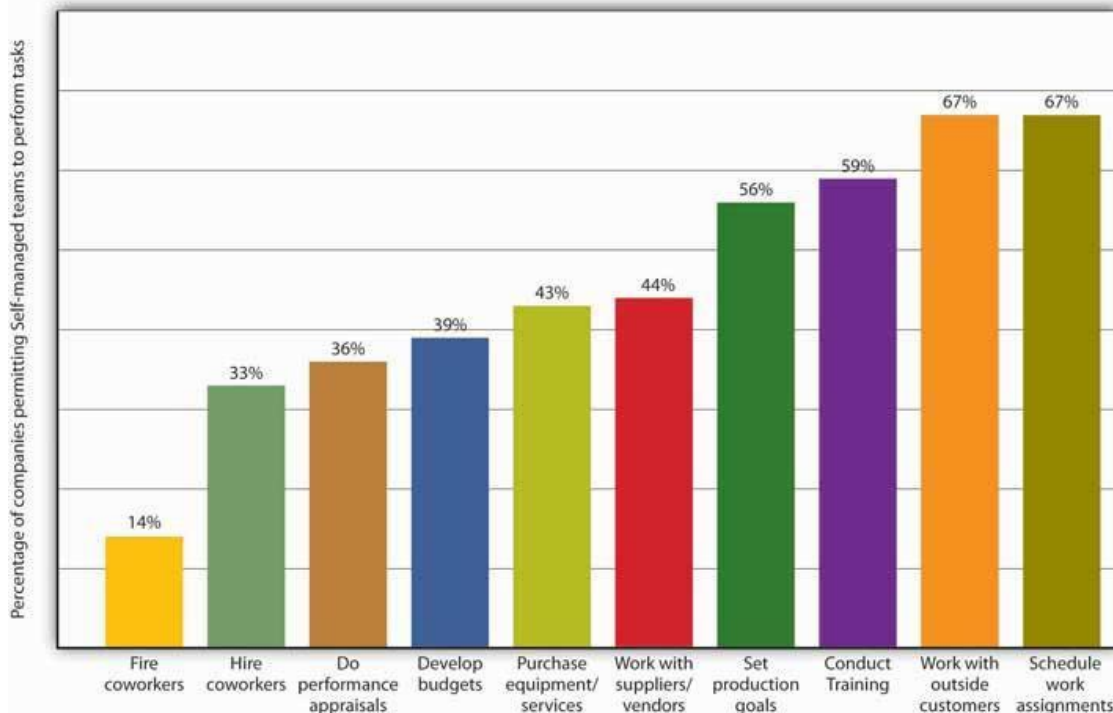


Figure 43 What Teams Do (and Don't) Manage

Cross-Functional Teams

Many companies use cross-functional teams—teams that, as the name suggests, cut across an organization's *functional areas* (operations, marketing, finance, and so on). A cross-functional team is designed to take advantage of the special expertise of members drawn from different functional areas of the company. When the Internal Revenue Service, for example, wanted to study the effects on employees of a major change in information systems, it created a cross-functional team composed of people from a wide range of departments. The final study reflected expertise in such areas as job analysis, training, change management, industrial psychology, and even ergonomics.²⁰⁶

Cross-functional teams figure prominently in the product-development process at Nike, where they take advantage of expertise from both inside and outside the company. Typically, team members include not only product designers, marketing specialists, and accountants but also sports-research experts, coaches, athletes, and even consumers. Likewise, Motorola's RAZR team was a cross-functional team: Responsibility for

developing the new product wasn't passed along from the design team to the engineering team but rather was entrusted to a special team composed of both designers and engineers.

We can also classify the RAZR team as a *product-development* or *project team* (a topic we'll discuss in more detail in Chapter 10 "Product Design and Development"). *Committees* and *task forces*, both of which are dedicated to specific issues or tasks, are often cross-functional teams. *Problem-solving teams*, which are created to study such issues as improving quality or reducing waste, may be either intradepartmental or cross-functional.²⁰⁷

Virtual Teams

"Teamwork," said someone (we're not sure who), "doesn't tolerate the inconvenience of distance." Indeed, technology now makes it possible for teams to function not only across such organizational boundaries as functional areas, departments, and divisions but also across time and space, as well. Working in virtual teams, geographically dispersed members interact electronically in the process of pursuing a common goal. Such technologies as videoconferencing, instant messaging, and electronic meetings, which allow people to interact simultaneously and in real time, offer a number of advantages in conducting the business of a virtual team.²⁰⁸ Among other things, members can participate from any location or at any time of day, and teams can "meet" for as long as it takes to achieve a goal or solve a problem—a few days, a few weeks, or a few months.

Nor does team size seem to be an obstacle when it comes to calling virtual-team meetings: In building the F-35 Strike Fighter, U.S. defense contractor Lockheed Martin staked the \$225 billion project on a virtual product-team of unprecedented global dimension, drawing on designers and engineers from the ranks of eight international partners ranging from Canada and the United Kingdom to Norway and Turkey.²⁰⁹

Key Takeaways

- Teamwork brings diverse areas of expertise to bear on organizational problems and projects.
- Reaching teamwork goals requires skills in negotiating trade-offs, and teamwork brings these skills into play at almost every step in the process.

- To be successful, teams need a certain amount of autonomy and authority in making and implementing their decisions.
- A **team** (or a *work team*) is a group of people with complementary skills who work together to achieve a specific goal. Members of a *working group* work independently and meet primarily to share information.
- Work teams have five key characteristics:
 1. They are accountable for achieving specific common goals.
 2. They function interdependently.
 3. They are stable.
 4. They have authority.
 5. They operate in a social context.
- Companies build and support teams because of their effect on overall workplace performance, both organizational and individual.
- Work teams may be of several types:
 1. In the traditional **manager-led team**, the leader defines the team's goals and activities and is responsible for its achieving its assigned goals.
 2. The leader of a **self-managing team** may determine overall goals, but employees control the activities needed to meet them.
 3. A **cross-functional team** is designed to take advantage of the special expertise of members drawn from different functional areas of the company.
 4. On **virtual teams**, geographically dispersed members interact electronically in the process of pursuing a common goal.

Why Teamwork Works

Learning Objectives

1. Explain why teams may be effective or ineffective.
2. Identify factors that contribute to team cohesiveness.

Now that we know a little bit about *how* teams work, we need to ask ourselves *why* they work. Not surprisingly, this is a fairly complex issue. In this section, we'll answer these closely related questions: Why are teams often effective? Why are they sometimes *ineffective*?

Factors in Effective Teamwork

First, let's begin by identifying several factors that, in practice, tend to contribute to effective teamwork. Generally speaking, teams are effective when the following factors are met:²¹⁰

- *Members depend on each other.* When team members rely on each other to get the job done, team productivity and efficiency are high.
- *Members trust one another.* Teamwork is more effective when members trust each other.
- *Members work better together than individually.* When team members perform better as a group than alone, collective performance exceeds individual performance.
- *Members become boosters.* When each member is encouraged by other team members to do his or her best, collective results improve.
- *Team members enjoy being on the team.* The more that team members derive satisfaction from being on the team, the more committed they become.
- *Leadership rotates.* Teams function effectively when leadership responsibility is shared over time.

Most of these explanations probably make pretty clear intuitive sense. Unfortunately, because such issues are rarely as clear-cut as they may seem at first glance, we need to examine the issue of group effectiveness from another perspective—one that considers the effects of factors that aren't quite so straightforward.

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Group Cohesiveness

The idea of group cohesiveness refers to the *attractiveness* of a team to its members. If a group is high in cohesiveness, membership is quite satisfying to its members; if it's low in cohesiveness, members are unhappy with it and may even try to leave it. The principle of group cohesiveness, in other words, is based on the simple idea that groups are most effective when their members like being members of the group.²¹¹

What Makes a Team Cohesive?

Numerous factors may contribute to team cohesiveness, but in this section, we'll focus on five of the most important:

1. *Size*. The bigger the team, the less satisfied members tend to be. When teams get too large, members find it harder to interact closely with other members; a few members tend to dominate team activities, and conflict becomes more likely.
2. *Similarity*. People usually get along better with people like themselves, and teams are generally more cohesive when members perceive fellow members as people who share their own attitudes and experience.
3. *Success*. When teams are successful, members are satisfied, and other people are more likely to be attracted to their teams.
4. *Exclusiveness*. The harder it is to get into a group, the happier the people who are already in it. Status (the extent to which outsiders look up to a team, as well as the perks that come with membership) also increases members' satisfaction.
5. *Competition*. Members value membership more highly when they're motivated to achieve common goals—especially when those goals mean outperforming other teams.

There's such a thing as too much cohesiveness. When, for instance, members are highly motivated to collaborate in performing the team's activities, the team is more likely to be effective in achieving its goals. Clearly, when those goals are aligned with the goals of the larger organization, the organization, too, will be happy. If, however, its members get too wrapped up in more immediate team goals, the whole team may lose sight of the larger organizational goals toward which it's supposed to be working.

Groupthink

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Likewise, it's easier for leaders to direct members toward team goals when members are all on the same page—when there's a basic willingness to conform to the team's rules and guidelines. When there's too much conformity, however, the group can become ineffective: It may resist change and fresh ideas and, what's worse, may end up adopting its own dysfunctional tendencies as its way of doing things. Such tendencies may also encourage a phenomenon known as groupthink—the tendency to conform to group pressure in making decisions, while failing to think critically or to consider outside influences.

Groupthink is often cited as a factor in the explosion of the space shuttle *Challenger* in January 1986: Engineers from a supplier of components for the rocket booster warned that the launch might be risky because of the weather but were persuaded to reverse their recommendation by NASA officials who wanted the launch to proceed as scheduled.²¹²

Why Teams Fail

Teams don't always work. To learn why, let's take a quick look at four common obstacles to success in introducing teams into an organization:²¹³

- *Unwillingness to cooperate.* Failure to cooperate can occur when members don't or won't commit to a common goal or set of activities. What if, for example, half the members of a product-development team want to create a brand-new product and half want to improve an existing product? The entire team may get stuck on this point of contention for weeks or even months.
- *Lack of managerial support.* Every team requires organizational resources to achieve its goals, and if management isn't willing to commit the needed resources—say, funding or key personnel—a team will probably fall short of those goals.
- *Failure of managers to delegate authority.* Team leaders are often chosen from the ranks of successful supervisors—first-line managers who, as we saw in Chapter 6 "Managing for Business Success", give instructions on a day-to-day basis and expect to have them carried out. This approach to workplace activities may not work very well in leading a team—a position in which success depends on building a consensus and letting people make their own decisions.
- *Failure of teams to cooperate.* If you're on a workplace team, your employer probably depends on teams to perform much of the organization's work and meet

many of its goals. In other words, it is, to some extent, a team-based organization, and as such, reaching its overall goals requires a high level of cooperation *among teams*.²¹⁴ When teams can't agree on mutual goals (or when they duplicate efforts), neither the teams nor the organization is likely to meet with much success.

Motivation and Frustration

Finally, remember that teams are composed of people, and whatever the roles they happen to be playing at a given time, people are subject to psychological ups and downs. As members of workplace teams, they need motivation, and as we observed in Chapter 7 "Recruiting, Motivating, and Keeping Quality Employees", when motivation is down, so are effectiveness and productivity. As you can see in Figure 2 "Sources of Frustration", the difficulty of maintaining a high level of motivation is the chief cause of frustration among members of teams. As such, it's also a chief cause of ineffective teamwork, and that's one reason why more employers now look for the ability to develop and sustain motivation when they're hiring new managers.²¹⁵

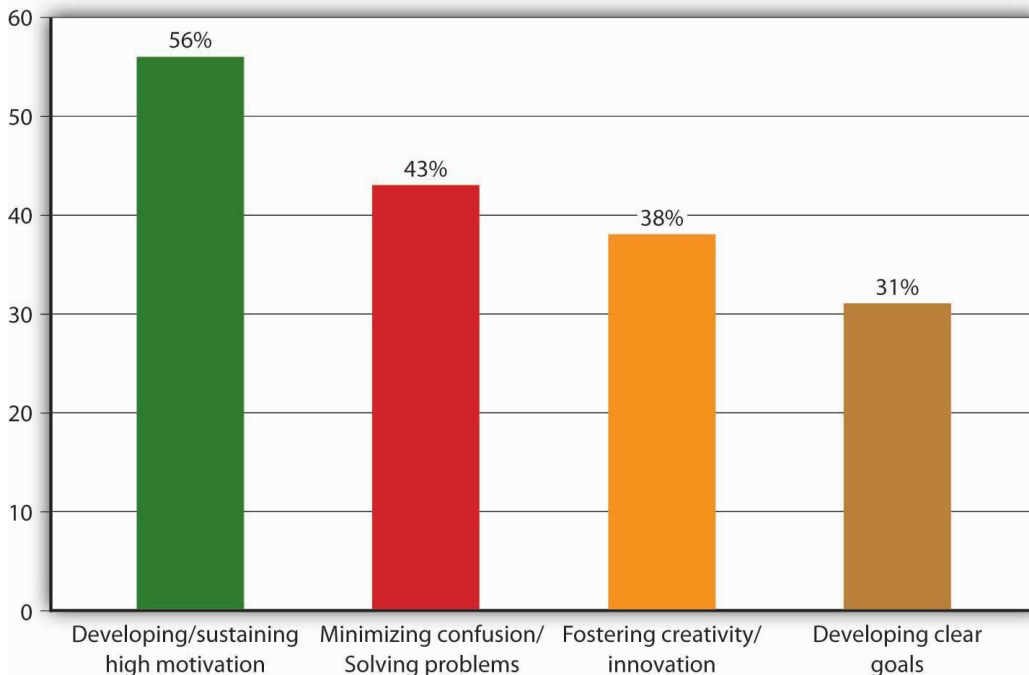


Figure 44 Sources of Frustration

Key Takeaways

- Generally speaking, teams are effective when the following are true:
 - Members are interdependent.
 - Members work better together than individually.
 - Teams work well enough to satisfy members.
 - Leadership rotates.
 - Members help one another.
 - Members become boosters.
 - Members trust one another.

- Group cohesiveness refers to the *attractiveness* of a team to its members. If a group is high in cohesiveness, membership is quite satisfying to its members; if it's low in cohesiveness, members are unhappy with it and may even try to leave it.
- Common obstacles to team success include the following:
 - Unwillingness to cooperate
 - Lack of managerial support
 - Failure of managers to delegate authority
 - Failure of teams to cooperate

The Team and Its Members

Learning Objectives

1. Understand the importance of learning to participate in team-based activities.
2. Identify the skills needed by team members and the roles that members of a team might play.
3. Learn how to survive team projects in college (and actually enjoy yourself).
4. Explain the skills and behaviors that foster effective team leadership.

“Life Is All about Group Work”

“I’ll work extra hard and do it myself, but please don’t make me have to work in a group.”

Like it or not, you'll probably be given some teamwork assignments while you're in college. More than two-thirds of all students report having participated in the work of an organized team, and if you're in business school, you will almost certainly find yourself engaged in team-based activities.²¹⁶

Why do we put so much emphasis on something that, reportedly, makes many students feel anxious and academically drained? Here's one college student's practical-minded answer to this question:

"In the real world, you have to work with people. You don't always know the people you work with, and you don't always get along with them. Your boss won't particularly care, and if you can't get the job done, your job may end up on the line. Life is all about group work, whether we like it or not. And school, in many ways, prepares us for life, including working with others."²¹⁷

She's right. In placing so much emphasis on teamwork skills and experience, college business departments are doing the responsible thing—preparing students for the business world that awaits them. A survey of *Fortune* 1000 companies reveals that 79 percent already rely on self-managing teams and 91 percent on various forms of employee work groups. Another survey found that the skill that most employers value in new employees is the ability to work in teams.²¹⁸ If you're already trying to work your way up an organizational ladder, consider the advice of former Chrysler Chairman Lee Iacocca: "A major reason that capable people fail to advance is that they don't work well with their colleagues."²¹⁹ The importance of the ability to work in teams was confirmed in a survey of leadership practices of more than sixty of the world's top organizations.²²⁰ When top executives in these organizations were asked, "What causes high-potential leadership candidates to derail? (stop moving up in the organization)," 60 percent of the organizations cited "inability to work in teams." Interestingly, only 9 percent attributed the failure of these executives to advance to "lack of technical ability." While technical skills will be essential in your getting hired into an organization, your team skills will play a significant role in your ability to advance.

To be team-ready or not to be team-ready—that is the question. Or, to put it in plainer terms, the question is not whether you'll find yourself working as part of a team. You will.

The question is whether you'll know how to participate successfully in team-based activities.

Will You Make a Good Team Member?

What if your instructor in this course decides to divide the class into several three-, four-, or five-member teams and assigns each team to develop a new product plus a business plan to get it into production and out on the market? What teamwork skills could you bring to the table? What teamwork skills do you need to work on? What qualities do you possess that might make you a good team leader?

What Skills Does the Team Need?

Sometimes we hear about a sports team made up of mostly average players who win a championship because of coaching genius, flawless teamwork, and superhuman determination.²²¹ But not terribly often. In fact, we usually hear about such teams simply because they're newsworthy—exceptions to the rule. Typically a team performs well because its members possess some level of talent. This doesn't mean, however, that we should reduce team performance to the mere sum of its individual contributions: Members' talents aren't very useful if they're not managed in a collective effort to achieve a common goal.

In the final analysis, of course, a team can succeed only if its members provide the skills that need managing. In particular, every team requires some mixture of three sets of skills:

- *Technical skills.* Because teams must perform certain tasks, they need people with the skills to perform them. For example, if your project calls for a lot of math work, it's good to have someone with the necessary quantitative skills.
- *Decision-making and problem-solving skills.* Because every task is subject to problems, and because handling every problem means deciding on the best solution, it's good to have members who are skilled in identifying problems, evaluating alternative solutions, and deciding on the best options.
- *Interpersonal skills.* Because teams are composed of people, and because people

need direction and motivation and depend on communication, every group benefits from members who know how to listen, provide feedback, and smooth ruffled feathers. The same people are usually good at communicating the team's goals and needs to outsiders.

The key to success is ultimately the right mix of these skills. Remember, too, that no team needs to possess all these skills—never mind the right balance of them—from day one. In many cases, a team gains certain skills only when members volunteer for certain tasks and perfect their skills in the process of performing them. For the same reason, effective teamwork develops over time as team members learn how to handle various team-based tasks. In a sense, teamwork is always work in progress.

What Roles Do Team Members Play?

Like your teamwork skills, expect your role on a team to develop over time. Also remember that, both as a student and as a member of the workforce, you'll be a *member* of a team more often than a *leader* (a subject that we'll take up in the next section). Team members, however, can have as much impact on a team's success as its leaders. The key is the quality of the contributions they make in performing non-leadership roles.²²²

What, exactly, are those roles? At this point, you've probably concluded that every team faces two basic challenges:

1. Accomplishing its assigned task
2. Maintaining or improving group cohesiveness

Whether you affect the team's work positively or negatively depends on the extent to which you help it or hinder it in meeting these two challenges.²²³ We can thus divide teamwork roles into two categories, depending on which of these two challenges each role addresses. These two categories (task-facilitating roles and relationship-building roles) are summarized in Table 8.2 "Roles that Team Members Play"²²⁴.

Table 7 Roles that Team Members Play

Task-facilitating Roles	Example	Relationship-building Roles	Example
Direction giving	“Jot down a few ideas and we’ll see what everyone has come up with.”	Supporting	“Now, that’s what I mean by a practical application.”
Information seeking	“Does anyone know if this is the latest data we have?”	Harmonizing	“Actually, I think you’re both saying pretty much the same thing.”
Information giving	“Here are latest numbers from....”	Tension relieving	“Before we go on to the next section, how many people would like a pillow?”
Elaborating	“I think a good example of what you’re talking about is....”	Confronting	“How does that suggestion relate to the topic that we’re discussing?”
Urging	“Let’s try to finish this proposal before we adjourn.”	Energizing	“It’s been a long time since I’ve had this many laughs at a meeting in <i>this</i> department.”
Monitoring	“If you’ll take care of the first section, I’ll make sure that we have the second by next week.”	Developing	“If you need some help pulling the data together, let me know.”
Process analyzing	“What happened to the energy level in this room?”	Consensus building	“Do we agree on the first four points even if number five needs a little more work?”
Reality testing	“Can we make this work and stay within budget?”	Empathizing	“It’s not you. The numbers <i>are</i> confusing.”
Enforcing	“We’re getting off track. Let’s try to stay on topic.”		
Summarizing	“Before we jump ahead, here’s what we’ve decided so far.”		

Task-Facilitating Roles

Task-facilitating roles address challenge number one—accomplishing the team goals. As you can see from Table 2 "Roles that Team Members Play", such roles include not only providing information when someone else needs it but also asking for it when you need it.

In addition, it includes *monitoring* (checking on progress) and *enforcing* (making sure that



team decisions are carried out). Task facilitators are especially valuable when assignments aren't clear or when progress is too slow. Moreover, every team needs people who recognize when a little task facilitation is called for.

Relationship-Building Roles

When you challenge unmotivated behavior or help other team members understand their roles, you're performing a relationship-building role and addressing challenge number two—maintaining or improving group cohesiveness. This type of role includes just about every activity that improves team “chemistry,” from *confronting* to *empathizing*.

Bear in mind three points about this model of team-membership roles: (1) Teams are most effective when there's a good balance between task facilitation and relationship building; (2) it's hard for any given member to perform both types of roles, as some people are better at focusing on tasks and others on relationships; and (3) overplaying any facet of any role can easily become counterproductive. For example, *elaborating* on something may not be the best strategy when the team needs to make a quick decision; and *consensus building* may cause the team to overlook an important difference of opinion.

Blocking Roles

Finally, review Table 8.3 "How to Block Teamwork"²²⁵, which summarizes a few characteristics of another kind of team-membership role. So-called blocking roles consist of behavior that inhibits either team performance or that of individual members. Every member of the team should know how to recognize blocking behavior. If teams don't confront dysfunctional members, they can destroy morale, hamper consensus building, create conflict, and hinder progress.

Table 8 How to Block Teamwork

Blocking Strategy	Tactics
Dominate	Talk as much as possible; interrupt and interject
Overanalyze	Split hairs and belabor every detail
Stall	Frustrate efforts to come to conclusions: decline to agree, sidetrack the discussion, rehash old ideas
Remain passive	Stay on the fringe; keep interaction to a minimum; wait for others to take on work
Overgeneralize	Blow things out of proportion; float unfounded conclusions
Find fault	Criticize and withhold credit whenever possible
Make premature decisions	Rush to conclusions before goals are set, information is shared, or problems are clarified
Present opinions as facts	Refuse to seek factual support for ideas that you personally favor
Reject	Object to ideas offered by people who tend to disagree with you
Pull rank	Use status or title to push through ideas, rather than seek consensus on their value
Resist	Throw up roadblocks to progress; look on the negative side
Deflect	Refuse to stay on topic; focus on minor points rather than main points

Class Team Projects

As we highlighted earlier, throughout your academic career you'll likely participate in a number of team projects. Not only will you make lasting friends by being a member of a team, but in addition you'll produce a better product. To get insider advice on how to

survive team projects in college (and perhaps really enjoy yourself in the process), let's look at some suggestions offered by two students who have gone through this experience.²²⁶

- *Draw up a team charter.* At the beginning of the project, draw up a team charter (or contract) that includes the goals of the group; ways to ensure that each team member's ideas are considered and respected; when and where your group will meet; what happens if a team member skips meetings or doesn't do his or her share of the work; how conflicts will be resolved.
- *Contribute your ideas.* Share your ideas with your group; they might be valuable to the group. The worst that could happen is that they won't be used (which is what would happen if you kept quiet).
- *Never miss a meeting.* Pick a weekly meeting time and write it into your schedule as if it were a class. Never skip it. And make your meetings productive.
- *Be considerate of each other.* Be patient, listen to everyone, communicate frequently, involve everyone in decision making, don't think you're always right, be positive, avoid infighting, build trust.
- *Create a process for resolving conflict.* Do this before conflict arises. Set up rules to help the group decide whether the conflict is constructive, whether it's personal, or whether it arises because someone won't pull his or her weight. Decide, as a group, how conflict will be handled.
- *Use the strengths of each team member.* Some students are good researchers, others are good writers, others have strong problem-solving or computer skills, while others are good at generating ideas. Don't have your writer do the research and your researcher do the writing. Not only would the team not be using its resources wisely, but two team members will be frustrated because they're not using their strengths.
- *Don't do all the work yourself.* Work with your team to get the work done. The project output is not as important as the experience of working in a team.
- *Set deadlines.* Don't leave everything to the end; divide up tasks, hold team members accountable, and set intermediary deadlines for each team member to get his or her work done. Work together to be sure the project is in on time and in good

shape.

What Does It Take to Lead a Team?

“Some people are born leaders, some achieve leadership, and some have leadership thrust upon them.” Or so Shakespeare might have said if he were managing a twenty-first-century work team instead of a sixteenth-century theater troupe. At some point in a successful career, whether in business, school, or any other form of organizational work, you may be asked (or assigned) to lead a team. The more successful you are, the more likely you are to receive such an invitation. So, what will you have to do as a leader? What skills will you need?

Like so many of the questions that we ask in this book, these questions don’t have any simple answers. As for the first question—what does a leader have to do?—we can provide one broad answer: A leader must help members develop the attitudes and behavior that contribute to team success: interdependence, collective responsibility, shared commitment, and so forth.

Influence Team Members and Gain their Trust

Team leaders must be able to influence their team members. And notice that we say *influence*: except in unusual circumstances, giving commands and controlling everything directly doesn’t work very well.²²⁷ As one team of researchers puts it, team leaders are more effective when they work *with* members rather than *on* them.²²⁸ Hand in hand with the ability to influence is the ability to gain and keep the *trust* of team members. People aren’t likely to be influenced by a leader whom they perceive as dishonest or selfishly motivated.

Assuming you were asked to lead a team, there are certain leadership skills and behaviors that would help you influence your team members and build trust. Let’s look at seven of these:

1. *Demonstrate integrity.* Do what you say you’ll do, and act in accordance with your stated values. Be honest in communicating with members, and follow through on promises.

2. *Be clear and consistent.* Let members know that you’re certain about what you want,

and remember that being clear and consistent reinforces your credibility.

3. *Generate positive energy.* Be optimistic and compliment team members. Recognize their progress and success.
4. *Acknowledge common points of view.* Even if you're about to propose some kind of change, before embarking on a new stage of a project recognize the value of the views that members already hold in common.
5. *Manage agreement and disagreement.* When members agree with you, focus on your point of view and present it reasonably. When they disagree with you, acknowledge both sides of the issue and support your own with strong, clearly presented evidence.
6. *Encourage and coach.* Buoy up members when they run into new and uncertain situations and when success depends on their performing at a high level. Give them the information they need and otherwise help them to perform tasks.
7. *Share information.* Let members know that you're knowledgeable about team tasks and individual talents. Check with team members regularly to find out what they're doing and how the job is progressing. Collect information from outside sources, and make sure that it gets to the team members who need it.

Key Takeaways

- As the business world depends more and more on teamwork, it's increasingly important for incoming members of the workforce to develop skills and experience in team-based activities.
- Every team requires some mixture of three skill sets:
 1. Technical skills: *skills needed to perform specific tasks*
 2. Decision-making and problem-solving skills: *skills needed to identify problems, evaluate alternative solutions, and decide on the best options*
 3. Interpersonal skills: skills in listening, providing feedback, and resolving conflict
- Team members deal with two basic challenges:
 1. Accomplishing the team's assigned task
 2. Maintaining or improving group cohesiveness.
- Task-facilitating roles address challenge number one—accomplishing team tasks. Relationship-building roles address challenge number two—maintaining or improving group cohesiveness. Blocking roles consist of behavior that inhibits either team performance or that of individual members.
- The following are eight ways to add value to and survive team projects in college:
 1. Draw up a team charter.
 2. Contribute your ideas.
 3. Never miss a meeting.
 4. Be considerate of each other.
 5. Create a process for resolving conflict.
 6. Use the strengths of each team member.
 7. Don't do all the work yourself.
 8. Set deadlines.
- The following are seven types of skills and behaviors that help team leaders influence their members and gain their trust:
 1. Demonstrating integrity
 2. Being clear and consistent

3. Generating positive energy
4. Acknowledging common points of view
5. Managing agreement and disagreement
6. Encouraging and coaching
7. Sharing information

The Business of Communication

Learning Objectives

1. Discuss the role of communication in the design of the RAZR cell phone.
2. Define communication and discuss the ways in which organizations benefit from effective communication.

Communication by Design

As the chief designer assigned to the “thin-clam” team at Motorola, Chris Arnholt was responsible for some of the phone’s distinctive physical features, including its sleek aluminum finish and backlit keyboard. In fact, it was he who pushed the company’s engineers and marketers to buck an industry trend toward phones that were getting fatter because of many add-ons such as cameras and stereo speakers. For Arnholt had a vision. He called it “rich minimalism,” and his goal was to help the Motorola cell phone team realize a product that embodied that profile.

But what exactly did Arnholt mean by rich minimalism? “Sometimes,” he admits, “my ideas are tough to communicate,” but as a veteran in his field, he also understands that “design is really about communication.”²²⁹ His chief (and ongoing) task, then, was communicating to the cell phone team what he meant by rich minimalism. Ultimately, of course, he had to show them what rich minimalism looked like when it appeared in tangible form in a fashionable new cell phone. In the process, he also had to be sure that the cell phone included certain key benefits that prospective consumers would want. As always, the physical design of the finished product had to be right for its intended market.

We’ll have much more to say about the process of developing new products in Chapter 10 “Product Design and Development”. Here, however, let’s simply highlight two points about

the way successful companies approach the challenges of new-product design and development (which you will likely recognize from reading the first part of this chapter):

1. In contributing to the new-product design and development process, industrial designers like Chris Arnholt must effectively communicate both ideas and practical specifications.
2. The design and development process usually succeeds only when the assigned team integrates input from every relevant area of the organization.²³⁰

The common denominator in both facets of the process is effective communication. The designer, for example, must communicate not only his vision of the product but also certain specifications for turning it into something concrete. Chris Arnholt sculpted models out of cornstarch and then took them home at night to refashion them according to suggestions made by the product team. Then he'd put his newest ideas on paper and hand the drawings over to another member of his design team, who'd turn them into 3D computer graphics from which other specialists would build plastic models. Without effective communication at every step in this process, it isn't likely that a group of people with different skills would produce plastic models bearing a practical resemblance to Arnholt's original drawings. On top of everything else, Arnholt's responsibility as chief designer required him to communicate his ideas not only about the product's visual and physical features but also about the production processes and manufacturing requirements for building it.²³¹

Thus Arnholt's job—which is to say, his responsibility on the cell phone team—meant that he had to do a lot more than merely design the product. Strictly speaking, the designer's function is to understand a product from the consumer's point of view; develop this understanding into a set of ideas and specifications that will satisfy not only consumer needs but producer requirements; and make recommendations through drawings, models, and verbal communications.²³² Even our condensed version of the RAZR story, however, indicates that Arnholt's job was far broader. Why? Because new-product design is an integrative process: contributions must come from all functions within an organization, including *operations* (which includes research and development, engineering and manufacturing), *marketing*, *management*, *finance*, and *accounting*.²³³

Our version of the RAZR story has emphasized operations (which includes research and development, engineering, and manufacturing) and touched on the role of marketing (which collects data about consumer needs). Remember, though, that members from several areas of management were recruited for the team. Because the project required considerable investment of Motorola's capital, finance was certainly involved, and the decision to increase production in late 2004 was based on numbers crunched by the accounting department. At every step, Arnholt's drawings, specs, and recommendations reflected his collaboration with people from all these functional areas. As we'll see in Section 8.4.2 "What Is Communication?", what all this interactivity amounts to is *communication*.²³⁴ As for what Arnholt meant by rich minimalism, you'll need to take a look at the picture of the RAZR at the beginning of the chapter. Among other things, it means a blue electroluminescent panel and a 22 kHz polyphonic speaker.

What Is Communication?

Let's start with a basic (and quite practical) definition of communication as the process of transferring information from a sender to a receiver. When you call up a classmate to inform him that your Introduction to Financial Accounting class has been canceled, you're sending information and your classmate is receiving it. When you go to your professor's Web site to find out the assignment for the next class, your professor is sending information and you're receiving it. When your boss e-mails you the data you need to complete a sales report and tells you to e-mail the report back to her by 4 o'clock, your boss is sending information and, once again, you're receiving it; later in the day, the situation will be reversed.

Your Ticket In (or Out)

Obviously, you participate in dozens of "informational transfers" every day. (In fact, they take up about 70 percent of your waking hours—80 percent if you have some sort of managerial position.)²³⁵ In any case, it wouldn't make much sense for us to pursue the topic much further without assuming that you've gained *some* experience and mastered *some* skills in the task of communicating. At the same time, though, we'll also venture to guess that you're much more comfortable having casual conversations with friends than writing class assignments or giving speeches in front of classmates. That's why we're going to resort to the same plain terms that we used when we discussed the likelihood of

your needing teamwork skills in an organizational setting: The question is not whether you'll need communication skills (both written and verbal). You will. The question is whether you'll develop the skills to communicate effectively in a variety of organizational situations.

Once again, the numbers back us up. In a recent survey by the Association of Colleges and Employers, the ability to communicate well topped the list of skills that business recruiters want in potential hires.²³⁶ A College Board survey of 120 major U.S. companies concludes that writing is a “threshold skill” for both employment and promotion. “In most cases,” volunteered one human resources director, “writing ability could be your ticket in—or your ticket out.” Applicants and employees who can’t write and communicate clearly, says the final report, “will not be hired and are unlikely to last long enough to be considered for promotion.”²³⁷

Why Are Communication Skills Important?

They're important to you because they're important to prospective employers. And why do employers consider communication skills so important? Because they're good for business. Research shows that businesses benefit in several ways when they're able to foster effective communication among employees:²³⁸

- Decisions are more convincing and certain, and problem solving is faster.
- Warning signs of potential problems appear earlier.
- Workflow moves more smoothly and productivity increases.
- Business relationships are stronger.
- Marketing messages are more persuasive.
- The company's professional image is enhanced.
- Employee satisfaction goes up and turnover goes down.
- The firm and its investors enjoy better financial results.

What Skills Are Important?

Figure 3 "Required Skills" reveals some further findings of the College Board survey that we mentioned previously—namely, the percentage of companies that identified certain communication skills as being “frequently” or “almost always” necessary in their workplaces. As you can see, ability in using e-mail is a nearly universal requirement (and

in many cases this includes the ability to adapt messages to different receivers or compose persuasive messages when necessary). The ability to make presentations (with visuals) also ranks highly.

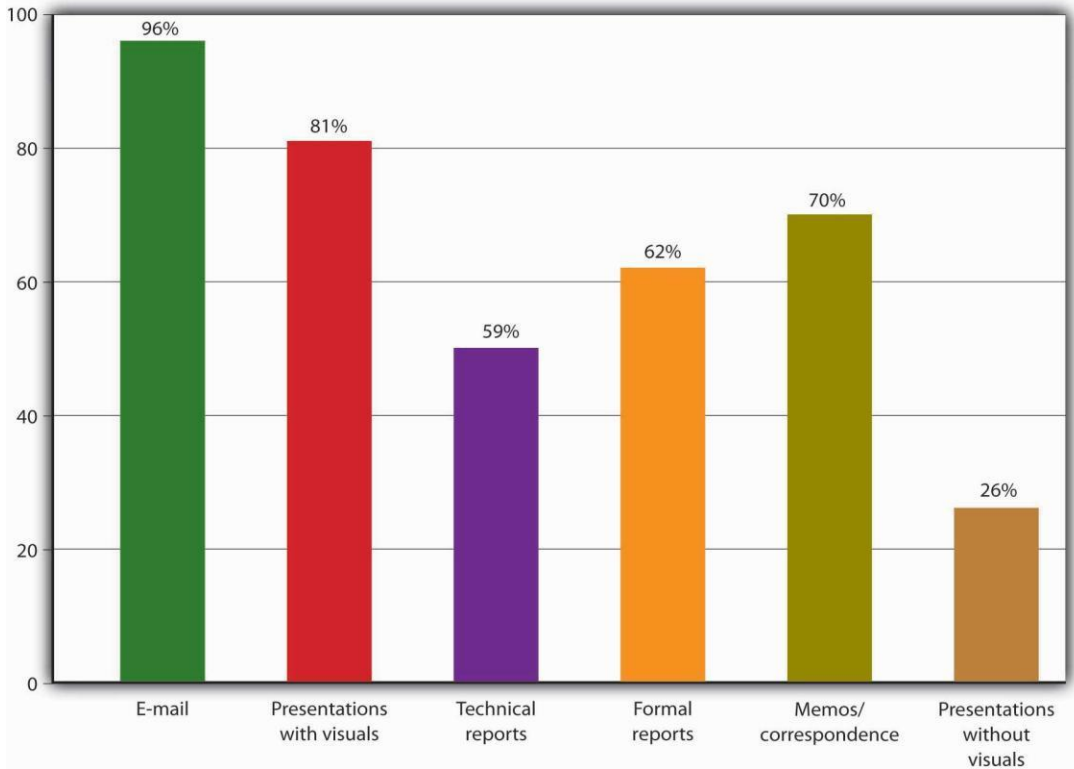


Figure 45 Required Skills

Key Takeaways

- Effective communication is needed in several facets of the new-product design and development process:
 1. *Designers must effectively communicate both ideas and practical specifications.*
 2. *The process usually succeeds only when the assigned team integrates input from every relevant area of the organization.*
- **Communication** is the process of transferring information from a sender to a receiver.
- Businesses benefit in several ways when they're able to foster effective communication among employees:
 1. *Decisions are more assured and cogent, and problem solving is faster.*
 2. *Warning signs of potential problems appear earlier.*

3. *Workflow moves more smoothly and productivity increases.*
4. *Business relationships are stronger.*
5. *Marketing messages are more persuasive.*
6. *The company's professional image is enhanced.*
7. *Employee satisfaction goes up and turnover goes down.*
8. *The firm and its investors enjoy better financial results.*

Communication Channels

Learning Objectives

1. Discuss the nature of communications in an organizational setting, including communication flows, channels, and networks.
2. Explain barriers to communication, and discuss the most common types of barriers to group communication.

What Is *Organizational* Communication?

Clearly, the task of preparing and submitting a finished sales report doesn't require the same kinds of communication skills as talking on the phone with a classmate. No matter

what your “workstation” happens to be—whether your workplace office or your kitchen table—you’re performing the task of preparing that sales report in an *organizational setting*. You’re still a sender transferring information to a receiver, but the organizational context of the task requires you to consider different factors for success in communicating effectively (including barriers to success). A report, for example, must be targeted for someone in a specific position and must contain the information necessary to make a specific set of decisions.²³⁹

Communication Flows

Here’s another way of thinking about communication in an organizational setting. Let’s assume that you and the classmate you called on the phone are on roughly equal footing—you’re both juniors, your grades in the class are about the same, and so forth. Your phone conversation, therefore, is “lateral”: You belong to the same group (your accounting class), and your group activities take place on the same level.

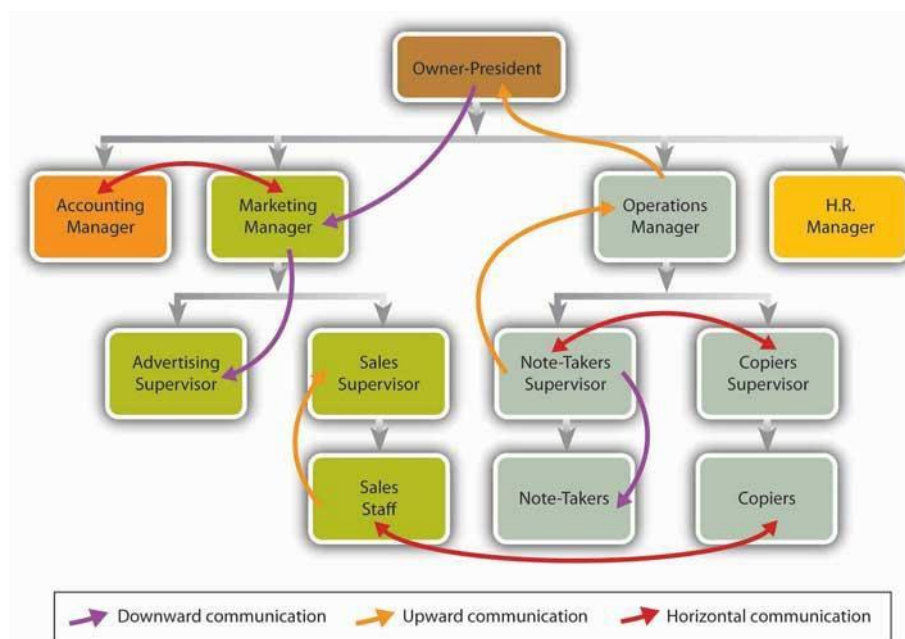


Figure 46 Formal Communication Flows

Communication may also flow laterally in organizational settings (as it does between you and your classmate), but more often it flows up or down. Take a look at Figure 4 "Formal Communication Flows". If it looks familiar, that’s because we’ve borrowed it from

Chapter 6 "Managing for Business Success", where it appeared as the *organization chart* for the fictional company Notes-4-You. As you can see, we’ve added a few lines to show the three directions in which communications can flow in a typical organization:²⁴⁰

1. As the term suggests, *downward communication* flows from higher organizational

- levels (supervisors) to lower organizational levels (subordinates).
2. *Upward communication* flows from lower to higher organizational levels.
 3. *Lateral (or horizontal) communication* flows across the organization, among personnel on the same level. Your boss's request for a sales report is an instance of downward communication, and when you've finished and submitted it, you will have completed a task of upward communication.

Advantages of Communication Flows

Naturally, each of these different directional flows has its functions and advantages.

Downward communication, for example, is appropriate for giving instructions or directions—telling people what to do. (As a goal of communication, by the way, giving orders isn't as one-sided as it may seem. One of the things that employees—the receivers—most want to know is: What, exactly, does my job entail?)²⁴¹ Like a sales report, upward communication usually provides managers with information that they need for making decisions, but it's also the vehicle for new ideas, suggestions, and complaints. Horizontal communication supports efforts to coordinate tasks and otherwise help people work together.

Disadvantages of Communication Flows

And, of course, each type of flow has its disadvantages. As information seeps downward, for instance, it tends to lose some of its original clarity and often becomes distorted or downright wrong. (This is especially true when it's delivered orally.) In addition, unlike Donald Trump, most people who are responsible for using downward communication don't like delivering bad news (such as "You're fired" or, more commonly, "Your job is being phased out"); as a result, bad news—including bad news that happens to be important news—is often ignored or disguised. The same thing may happen when bad news—say, a negative status report—must be sent upward.

Finally, while horizontal flows are valuable for promoting cooperation, they can also be used to engage in conflict—for instance, between two departments competing for the same organizational resources. The problem is especially bad when such horizontal communications breach official upward or downward lines of communication, thus bypassing managers who might be able to resolve the conflict.

Channels of Communication

Figure 5 "Channels of Communication"

summarizes two additional sets of characteristics of organizational communication—*internal and external channels* and *formal and informal channels*.²⁴²

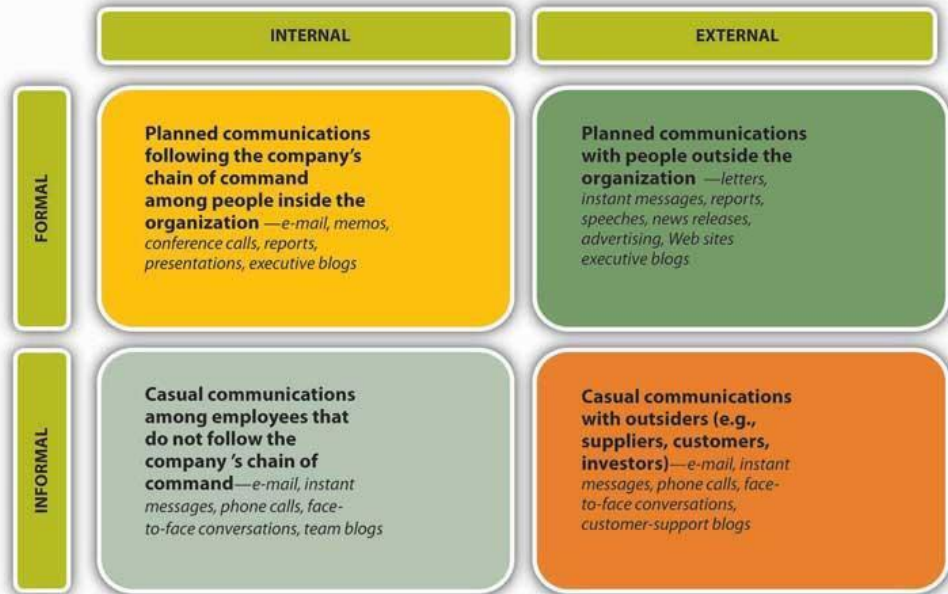


Figure 47 Channels of Communication

Internal

communication is shared by people at all levels within a company. External communication occurs between parties inside a company and parties outside the company, such as suppliers, customers, and investors. Both internal and external forms of communication include everything from formal e-mail and official reports to face-to-face conversations and casual phone calls. External communication also takes such forms as customer and supplier Web sites, news releases, and advertising.

Note that Figure 5 "Channels of Communication" takes the form of a grid, thus creating four dimensions in which communication can take place. Informal communication, for example, can take place either among people within the company (internally) or between insiders and outsiders (externally). By and large, though you can use the same set of tools (memos, reports, phone calls) to communicate in any of these four situations, some tools (team blogs, news releases, supplier Web sites) are useful only in one or two.

The Formal Communication Network

An organization's formal communication network consists of all communications that flow along its official lines of authority. Look again at Figure 4 "Formal Communication Flows". Because it incorporates the *organization chart* for Notes-4-You, it shows the company's lines of authority—what, in Chapter 6 "Managing for Business Success", we called its

reporting relationships. Here we can see that the reporting relationships in question consist of *upward communication* from subordinates to superiors. In reporting to the operations manager, for example, the notetakers' supervisor communicates upward. Conversely, when the notetakers' manager needs to give direction to notetakers, she will use *downward communication*. If the notetakers' manager and the copiers' manager must get together to prepare a joint report for the operations manager, they'll engage in *lateral communication*. In short, an organization's formal communication network is basically the same thing as its network of reporting relationships and lines of authority.²⁴³

The Informal Communication Network

Every company also has an informal communication network (or grapevine), which goes to work whenever two or more employees get together and start talking about the company and their jobs. Informal communication can take place just about anywhere (in one person's cubicle, in the cafeteria, on the golf course) and by just about any means (phone, e-mail, instant messaging, face-to-face conversation).

Though it's sometimes called the *grapevine*, an informal network is an extremely important communication channel. Why? For the simple reason that it's typically widespread and can rarely be prevented, even if it's not officially sanctioned by the company—indeed, even when the company tries to discourage or bypass it. Unofficial information crosses virtually every boundary drawn by a firm's organization chart, reaching out and touching everyone in the organization, and what's more, it travels a lot faster than official information.

Problems with the Flow of Information through Informal Channels

The downside of "unofficial" information should be obvious. Because much of it is communicated orally, it's likely to get distorted and often degenerates into outright misinformation. Say, for example, that a rumor about layoffs gets started in your workplace. As more than one manager will verify, such rumors can do more damage than the reality. Morale may plummet and productivity won't be far behind. Valuable employees may abandon ship (needlessly, if the rumors are false).²⁴⁴

And imagine what can happen if informal information gets outside the organization. In the 1970s, Chicago-area McDonald's outlets found themselves fighting rumors about worms in

their hamburgers. Over the years, Coca-Cola has had to fight rumors about terrorists joining its organization, subversive messages concealed in its label, and hyperacidity (false rumors that Coke causes osteoporosis and makes a good pesticide and an equally good spermicide).²⁴⁵

What to Do about Informal Information Flows

On the upside, savvy managers can tap into the informal network, either to find out what sort of information is influencing employee activities or to circulate more meaningful information, including new ideas as well as corrective information. In any case, managers have to deal with the grapevine, and one manager has compiled a list of suggestions for doing so effectively:²⁴⁶

- *Learn to live with it.* It's here to stay.
- *Tune into it.* Pay attention to the information that's circulating and try to learn something from it. Remember: The more you know about grapevine information, the better you can interact with employees (who, in turn, will probably come to regard you as someone who keeps in touch with the things that concern them).
- *Don't participate in rumors.* Resist the temptation to add your two cents' worth, and don't make matters worse.
- *Check out what you hear.* Because it's your job to replace bad information with good information, you need to find out what's really going on.
- *Take advantage of the grapevine.* Its only function is to carry information, so there's no reason why you can't pump some useful information through it.

Perhaps most importantly, when alert managers notice that the grapevine is particularly active, they tend to reach a sensible twofold conclusion:

1. The organization's formal lines of communication aren't working as well as they should be.
2. The best way to minimize informal communication and its potential damage is to provide better formal communication from the outset—or, failing that, to provide whatever formal communication will counteract misinformation as thoroughly as possible.

Let's go back to our example of a workplace overwhelmed by layoff rumors. In a practical sense, what can a manager—say, the leader of a long-term product-development team—do to provide better communication? One manager suggests at least three specific responses:²⁴⁷

1. Go to your supervisor or another senior manager and try to find out as much as you can about the organization's real plans.
2. Ask a senior manager or a human resources representative to meet with your team and address members' concerns with accurate feedback.
3. Make it a priority to keep channels open—both between yourself and your team members and between team members and the human resources department.

Because actions of this sort send a message, they can legitimately be characterized as a form of formal communication. They also reflect good leadership: Even though the information in this case relates only indirectly to immediate team tasks, you're sharing information with people who need it, and you're demonstrating integrity (you're being honest, and you're following through on a commitment to the team).

Overcoming Barriers to Communication, What Are Barriers to Communication?

By *barriers* we mean anything that prevents people from communicating as effectively as possible. Noise, for example, can be a barrier to communication; if you and other team members are mumbling among yourselves while your team leader is trying to explain task assignments, you're putting up a barrier to group communication. As a matter of fact, you're putting up two barriers: In addition to *creating noise*, you're *failing to listen*. About 80 percent of top executives say that learning to listen is the most important skill in getting things done in the workplace,²⁴⁸ and as President Calvin Coolidge once remarked, "No man ever listened himself out of a job." Business people who don't listen risk offending others or misinterpreting what they're saying.

Two Types of Barriers

As for creating unnecessary verbal noise and failing to listen, we can probably chalk them up to poor communication habits (or maybe the *same* habit, for as legendary management expert Peter Drucker argues, "Listening is not a skill; it is a discipline. All you have to do is

keep your mouth shut”). In the rest of this section, we’ll overlook personal barriers to communication and concentrate instead on two types of barriers that are encountered by groups of people, sometimes large and sometimes small, working toward organizational goals.

Cultural Barriers

Cultural barriers, which are sometimes called cultural filters, are the barriers that result from differences among people of different cultures.²⁴⁹ As we point out in Chapter 7 "Recruiting, Motivating, and Keeping Quality Employees", experts and managers agree that cultural diversity in the workplace can and should be a significant asset: It broadens the perspectives from which groups approach problems, gives them fresh ideas, and sparks their creativity; it also gives organizations an advantage in connecting with diverse customer bases. None of these advantages, though, magically appears simply because workplace diversity increases. To the contrary: As diversity increases, so does the possibility that a group will be composed of people who have different attitudes and different ways of expressing them.

If it hasn’t happened already, for example, one of these days you’ll find yourself having a work-related conversation with a member of the opposite sex. If the conversation doesn’t go as smoothly as you’d expected, there’s a good reason: Men and women in the workplace don’t communicate the same way. According to American linguist Deborah Tannen, men tend to assert their status, to exert confidence, and to regard asking questions as a sign of weakness. Women, in contrast, tend to foster positive interrelationships, to restrain expressions of confidence, and to ask questions with no trouble.²⁵⁰

It really doesn’t matter which “style” (if either) is better suited to making a conversation more productive. Two points, however, are clear:

1. Even if two people of the opposite sex enter a conversation with virtually identical viewpoints, their different styles of expressing themselves might very well present a barrier to their reaching an agreement. Much the same can be said of differences in style arising from other cultural filters, such as ethnicity, education, age, and experience.

2. Workplace conversations can be tricky to negotiate, yet there's no escaping them. Like life in the outside world, observes Tannen, life in the workplace "is a matter of dealing with people...and that means a series of conversations." That's also why surveys continue to show that managers regard the ability to communicate face to face as a key factor in an employee's promotability.²⁵¹

Functional Barriers

Let's return for a moment to Figure 4 "Formal Communication Flows". Recall that when we introduced the organizational structure of Notes-4-You in Chapter 6 "Managing for Business Success", we characterized it as a *functional organization*—one that groups together people who have comparable skills and perform similar tasks. Note, however, that in setting up this form of organization for our hypothetical company, we found it necessary to insert two layers of management (four functional managers and two job supervisors) between our owner/president and our lowest-level employees. In this respect, our structure shares certain characteristics with another form of organization—*divisional*, which groups people into units that are more or less self-contained and that are largely accountable for their own performance.

What does all this have to do with barriers to communication? Simply this: The more "divisionalized" an organization becomes, the more likely it will be to encounter communication barriers. Not surprisingly, communication gets more complicated, for the same reason that an organization comes to rely on more levels of management.²⁵² Notes-4-You, for instance, needs two supervisors because its notetakers don't do the same work as its copiers. In addition, because their groups don't perform the same work, the two supervisors don't call on the same resources from the company's four functional managers. (Likewise, Notes-4-You also has four functional-area managers because none of them does the same work as any of the others.)

Officially, then, the operations of the two work groups remain distinct or specialized. At the same time, each group must contribute to the company-wide effort to achieve common goals. Moreover, certain organizational projects, like Motorola's cell phone project, may require the two groups to work together more closely than usual. When that happens, employees from each of the two groups may find themselves working together on the

same team, but even so, one crucial fact remains: Information that one group possesses and the other doesn't must still be exchanged among team members. It may not be quite as apparent as the *cultural diversity* among men and women in many workplace situations, but there is in fact a *functional diversity* at Notes-4-You among notetakers and copiers.²⁵³

Figure 6 "Functional Barriers to Communication" illustrates the location of barriers that may be present when a team-based project must deal with a certain degree of functional diversity. As you can see, we've modeled our process on the process of the Motorola ultratrim phone project.²⁵⁴ We don't need to describe the entire process in detail, but we will focus on two aspects of it that we've highlighted in the drawing:

1. The company has assigned team members from different functional areas, notably marketing and operations (which, as at Motorola, includes design, engineering, and production).
2. Information (which we've characterized as different types of "specs") must be transferred from function to function, and at the key points where this occurs, we've built in communication barriers (symbolized by brick walls).

If, for example, marketing specs called for the new Motorola phone to change colors with the user's mood, someone in engineering might have to explain the difficulties in designing the software. If design specs called for quadraphonic sound, production might have to explain the difficulties in procuring sufficiently lightweight speaker components.

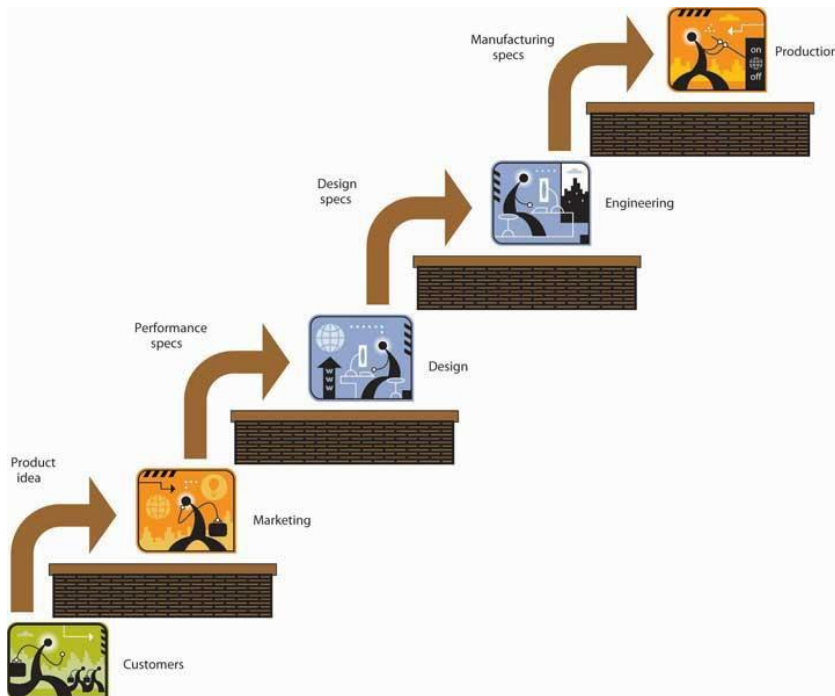


Figure 48 Functional Barriers to Communication

Each technical problem—each problem that arises because of differences in team members’ knowledge and expertise—becomes a problem in communication. In addition, communicating as a member of a team obviously requires much more than explaining the limitations of someone else’s professional expertise. Once they’ve surfaced, technical and other problems have to be

resolved—a process that will inevitably require even more communication. As we’ve seen in this part of the chapter, improving communication is a top priority for most organizations (for one thing, developing a team-based environment is otherwise impossible), and the ongoing task of improving communication is pretty much the same thing as the ongoing task of overcoming barriers to it.

Key Takeaways

- In a typical organizational setting, *communication flows* may take three directions:
 1. **Downward communication** flows from higher organizational levels (supervisors) to lower organizational levels (subordinates).
 2. **Upward communication** flows from lower to higher organizational levels.
 3. **Lateral (or horizontal) communication** flows across the organization, among personnel on the same level.
- Organizational communication flows through two different *channels*. **Internal communication** is shared by people at all levels within a company. **External communication** occurs between parties inside a company and parties outside the company, such as suppliers, customers, and investors.
- Organizational communication also flows through two different *networks*. Its **formal communication network** consists of all communications that flow along an organization's official lines of authority. The **informal communication network**, sometimes called the *grapevine*, goes to work whenever two or more employees get together and start talking about the company and their jobs.
- *Barriers to communication* include anything that prevents people from communicating as effectively as possible. Among groups, two types of barriers are common. *Cultural barriers*, sometimes called *cultural filters*, are the barriers that result from differences among people of different cultures. *Functional barriers* arise when communication must flow among individuals or groups who work in different functional areas of an organization.

Chapter 8 Review Questions

Multiple Choice:

- A _____ team is designed to take advantage of the special expertise of members.
 1. Manager-Led
 2. Self-Managing
 3. Cross-Functional
 4. Virtual
- Within a team, process analysis is an example of a _____ role.
 1. Task-facilitating
 2. Relationship-building
 3. Blocking
- Within a team, empathizing is an example of a _____ role.
 1. Task-facilitating
 2. Relationship-building
 3. Blocking
- _____ communication flows across the organization at the same level.
 1. Downward
 2. Upward
 3. Lateral
- _____ communication flows from supervisors to subordinates.
 1. Downward
 2. Upward
 3. Lateral

Short Answer:

1. What are the five key characteristics of work teams?
2. What are the three skill sets every team requires some mixture of to be successful?
3. What is the difference between cultural and functional communication barriers?

Chapter 9 Marketing: Providing Value to Customers

What Is Marketing?

Learning Outcomes

1. Define the terms marketing, marketing concept, and marketing strategy.
2. Outline the tasks involved in selecting a target market.

When you consider the functional areas of business—accounting, finance, management, marketing, and operations—marketing is the one you probably know the most about. After all, as a consumer and target of all sorts of advertising messages, you’ve been on the receiving end of marketing initiatives for most of your life. What you probably don’t appreciate, however, is the extent to which marketing focuses on providing value to the customer. According to the American Marketing Association, “Marketing is the activity, set of institutions, and processes for creating, communicating, delivering, and exchanging offerings that have value for customers, clients, partners, and society at large.”²⁵⁵ In other words, marketing isn’t just advertising and selling. It includes everything that organizations do to satisfy customer needs:

- Coming up with a product and defining its features and benefits
- Setting its price
- Identifying its target market
- Making potential customers aware of it
- Getting people to buy it
- Delivering it to people who buy it
- Managing relationships with customers after it has been delivered

Not surprisingly, marketing is a team effort involving everyone in the organization. Think about a typical business—a local movie theater, for example. It’s easy to see how the person who decides what movies to show is involved in marketing: he or she selects the

product to be sold. It's even easier to see how the person who puts ads in the newspaper works in marketing: he or she is in charge of advertising—making people aware of the product and getting them to buy it. But what about the ticket seller and the person behind the counter who gets the popcorn and soda? What about the projectionist? Are they marketing the business? Absolutely: the purpose of every job in the theater is satisfying customer needs, and as we've seen, identifying and satisfying customer needs is what marketing is all about.

If everyone is responsible for marketing, can the average organization do without an official marketing department? Not necessarily: most organizations have marketing departments in which individuals are actively involved in some marketing-related activity—product design and development, pricing, promotion, sales, and distribution. As specialists in identifying and satisfying customer needs, members of the marketing department manage—plan, organize, direct, and control—the organization's overall marketing efforts.

The Marketing Concept

Figure 1 "The Marketing Concept" is designed to remind you that to achieve business success you need to do three things:

1. Find out what customers or potential customers need.
2. Develop products to meet those needs.
3. Engage the entire organization in efforts to satisfy customers.



Figure 49 The Marketing Concept

At the same time, you need to achieve organizational goals, such as profitability and growth. This basic philosophy—satisfying customer needs while meeting organizational goals—is called the marketing concept, and when it's effectively applied, it guides all of an organization's marketing activities.

The marketing concept puts the customer first: as your most important goal, satisfying the customer must be the goal of everyone in the organization. But this doesn't mean that you ignore the bottom line; if you want to survive and grow, you need to make some profit. What you're looking for is the proper balance between the commitments to customer satisfaction and company survival. Consider the case of Medtronic, a manufacturer of medical devices, such as pacemakers and defibrillators. The company boasts more than 50 percent of the market in cardiac devices and is considered the industry standard setter.²⁵⁶ Everyone in the organization understands that defects are intolerable in products that are designed to keep people alive. Thus, committing employees to the goal of zero defects is vital to both Medtronic's customer base and its bottom line. "A single quality issue," explains CEO Arthur D. Collins Jr., "can deep-six a business."²⁵⁷

Marketing Strategy

Declaring that you intend to develop products that satisfy customers and that everyone in your organization will focus on customers is easy. The challenge is doing it. As you can see in Figure 2 "Marketing Strategy", to put the marketing concept into practice, you need a marketing strategy—a plan for performing two tasks:

1. Selecting a target market
2. Developing your *marketing mix*—implementing strategies for creating, pricing, promoting, and distributing products that satisfy customers



Figure 50 Marketing Strategy

We'll use Figure 2 "Marketing Strategy" as a blueprint for our discussion of target- market selection, and we'll analyze the concept of the marketing mix in more detail in Section 9.2 "The Marketing Mix".

Selecting a Target Market

As we saw earlier, businesses earn profits by selling goods or providing services. It would be nice if everybody in the marketplace was interested in your product, but if you tried to sell it to everybody, you'd spread your resources too thin. You need to identify a specific group of consumers who should be particularly interested in your product, who would have access to it, and who have the means to buy it. This group is your target market, and you'll aim your marketing efforts at its members.

Identifying Your Market

How do marketers identify target markets? First, they usually identify the overall market for their product—the individuals or organizations that need a product and are able to buy it. As Figure 2 "Marketing Strategy" shows, this market can include either or both of two groups:

1. A consumer market—buyers who want the product for personal use
2. An industrial market—buyers who want the product for use in making other products. You might focus on only one market or both. A farmer, for example, might sell blueberries to individuals on the consumer market and, on the industrial market, to bakeries that will use them to make muffins and pies.

Segmenting the Market

The next step in identifying a target market is to divide the entire market into smaller portions, or market segments—groups of potential customers with common characteristics that influence their buying decisions. You can use a number of characteristics to narrow a market. Let's look at some of the most useful categories in detail.

Demographic Segmentation

Demographic segmentation divides the market into groups based on such variables as age, marital status, gender, ethnic background, income, occupation, and education. Age, for example, will be of interest to marketers who develop products for children, retailers

who cater to teenagers, colleges that recruit students, and assisted-living facilities that promote services among the elderly. The wedding industry, which markets goods and services to singles who will probably get married in the near future, is interested in trends in marital status. Gender and ethnic background are important to TV networks in targeting different audiences. Lifetime Television for Women targets female viewers; Spike TV targets men; Telemundo networks target Hispanic viewers. If you're selling yachts, you'll want to find people with lots of money; so income is an important variable. If you're the publisher of *Nurses* magazine, you want to reach people in the nursing profession. When Hyundai offers recent (and upcoming) college graduates the opportunity to buy a new car with no money down, the company's marketers have segmented the market according to education level.²⁵⁸

Geographic Segmentation

Geographic segmentation—dividing a market according to such variables as climate, region, and population density (urban, suburban, small-town, or rural)—is also quite common. Climate is crucial for many products: try selling snow shovels in Hawaii or above-ground pools in Alaska. Consumer tastes also vary by region. That's why McDonald's caters to regional preferences, offering a breakfast of Spam and rice in Hawaii, tacos in Arizona, and lobster rolls in Massachusetts.²⁵⁹ Outside the United States, menus diverge even more widely (you can get seaweed burgers or, if you prefer, seasoned seaweed fries in Japan).²⁶⁰

Likewise, differences between urban and suburban life can influence product selection. As exhilarating as urban life can be, for example, it's a hassle to parallel park on crowded city streets. Thus, Toyota engineers have developed a product especially for city dwellers (at least in Japan). The Japanese version of the Prius, Toyota's hybrid gas-electric car, can automatically parallel park itself. Using computer software and a rear-mounted camera, the parking system measures the spot, turns the steering wheel, and swings the car into the space (making the driver—who just sits there—look like a master of urban survival skills).²⁶¹ After its success in the Japanese market, the self-parking feature was brought to the United States. So if you ever see a car doing a great job parallel parking without the driver touching the wheel, it is likely a self-parking Prius²⁶²

Behavioral Segmentation

Dividing consumers by such variables as attitude toward the product, user status, or usage rate is called behavioral segmentation. Companies selling technology-based products might segment the market according to different levels of receptiveness to technology. They could rely on a segmentation scale developed by Forrester Research that divides consumers into two camps: *technology optimists*, who embrace new technology, and *technology pessimists*, who are indifferent, anxious, or downright hostile when it comes to technology.²⁶³

Some companies segment consumers according to *user status*, distinguishing among nonusers, potential users, first-time users, and regular users of a product. Depending on the product, they can then target specific groups, such as first-time users. Credit-card companies use this approach when they offer frequent flyer miles to potential customers in order to induce them to get their card. Once they start using it, they'll probably be segmented according to usage. "Heavy users" who pay their bills on time will likely get increased credit lines.

Psychographic Segmentation

Psychographic segmentation classifies consumers on the basis of individual lifestyles as they're reflected in people's interests, activities, attitudes, and values. If a marketer profiled you according to your lifestyle, what would the result be? Do you live an active life and love the outdoors? If so, you may be a potential buyer of athletic equipment and apparel. Maybe you'd be interested in an eco-tour offered by a travel agency. If you prefer to sit on your couch and watch TV, you might show up on the radar screen of a TiVo provider. If you're compulsive or a risk taker, you might catch the attention of a gambling casino. If you're thrifty and uncomfortable with debt, Citibank might want to issue you a debit card.

Clustering Segments

Typically, marketers determine target markets by combining, or "clustering," segmenting criteria. What characteristics does Starbucks look for in marketing its products? Three demographic variables come to mind: age, geography, and income. Buyers are likely to be males and females ranging in age from about twenty-five to forty (although college students, aged eighteen to twenty-four, are moving up in importance). Geography is a factor as customers tend to live or work in cities or upscale suburban areas. Those with

relatively high incomes are willing to pay a premium for Starbucks specialty coffee and so income—a socioeconomic factor—is also important.

Key Takeaways

- **Marketing** is a set of processes for creating, communicating, and delivering value to customers and for improving customer relationships. It includes everything that organizations do to satisfy customers' needs.
- The philosophy of satisfying customers' needs while meeting organizational profit goals is called the **marketing concept** and guides all of an organization's marketing activities.
- To apply this approach, marketers need a **marketing strategy**—a plan for doing two things: selecting a target market and then implementing strategies for creating, pricing, promoting, and distributing products that satisfy customers' needs.
- A **target market** is a specific group of consumers who are particularly interested in a product, would have access to it, and are able to buy it.
- To identify this group, marketers first identify the overall market for the product (from the **consumer market**, the **industrial market**, or both).
- Then, they divide the market into **market segments**—groups of customers with common characteristics that influence their buying decisions.
- The market can be divided according to any of the following variables:
 - a. **Demographics** (age, gender, income, and so on)
 - b. **Geographics** (region, climate, population density)
 - c. **Behavior** (receptiveness to technology, usage)
 - d. **Psychographics** or lifestyle variables (interests, activities, attitudes, and values)

The Marketing Mix

Learning Outcomes

1. Identify the four Ps of the marketing mix.
2. Explain how to conduct marketing research.

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3. Discuss various branding strategies and explain the benefits of packaging and labeling.

After identifying a target market, your next step is developing and implementing a marketing program designed to reach it. As Figure 3 "The Marketing Mix" shows, this program involves a combination of tools called the marketing mix, often referred to as the "four Ps" of marketing:

1. Developing a *product* that meets the needs of the target market
2. Setting a *price* for the product
3. Distributing the product—getting it to a *place* where customers can buy it
4. *Promoting* the product—informing potential buyers about it



Figure 51 The Marketing Mix

The goal is to develop and implement a marketing strategy that combines these four elements. To see how this process works, let's look at Wow Wee Toys' marketing program for Robosapien.²⁶⁴

Developing a Product

The development of Robosapien was a bit unusual for a company that

was already active in its market. Generally, product ideas come from people within the company who understand its customers' needs. Internal engineers are then challenged to design the product. In the case of Robosapien, however, the creator, Mark Tilden, had conceived and designed the product before joining Wow Wee Toys. The company gave him the opportunity to develop the product for commercial purposes, and Tilden was brought on board to oversee the development of Robosapien into a product that satisfied Wow Wee's commercial needs.

Robosapien is not a "kid's toy," though kids certainly love its playful personality. It's a

home-entertainment product that appeals to a broad audience—children, young adults, older adults, and even the elderly. It’s a big gift item, and it has developed a following of techies and hackers who take it apart, tinker with it, and even retrofit it with such features as cameras and ice skates. In fact, Tilden wanted the robot to be customizable; that’s why he insisted that its internal parts be screwed together rather than soldered.

Conducting Marketing Research

Before settling on a strategy for Robosapien, the marketers at Wow Wee did some homework. First, to zero in on their target market, they had to find out what various people thought of the product. More precisely, they needed answers to questions like the following:

- Who are our potential customers? What are they like?
- Do people like Robosapien? What gets them excited about it? What don’t they like? What would they change?
- How much are they willing to pay for Robosapien?
- Where will they probably go to buy the product?
- How should it be promoted? How can we distinguish it from competing products?
- Will enough people buy Robosapien to return a reasonable profit?
- Should we go ahead and launch the product?

The last question would be left up to Wow Wee management, but, given the size of the investment needed to bring Robosapien to market, Wow Wee couldn’t afford to make the wrong decision. Ultimately, the company was able to make an informed decision because its marketing team provided answers to all the other questions. They got these answers through marketing research—the process of collecting and analyzing the data that are relevant to a specific marketing situation.

This data had to be collected in a systematic way. Market research seeks two types of data:

1. Marketers generally begin by looking at secondary data—information already collected, whether by the company or by others, that pertains to the target market.

2. Then, with secondary data in hand, they're prepared to collect primary data—newly collected information that addresses specific questions.

You can get secondary data from inside or outside the organization. Internally available data includes sales reports and other information on customers. External data can come from a number of sources. The U.S. Census Bureau, for example, posts demographic information on American households (such as age, income, education, and number of members), both for the country as a whole and for specific geographic areas. You can also find out whether an area is growing or declining.

Population data helped Wow Wee estimate the size of its potential U.S. target market. Other secondary data helped the firm assess the size of foreign markets in regions around the world, such as Europe, the Middle East, Latin America, Asia, and the Pacific Rim. This data positioned the company to sell Robosapien in eighty-five countries, including Canada, England, France, Germany, South Africa, Australia, New Zealand, Hong Kong, and Japan.

Using secondary data that are already available (and free) is a lot easier than collecting your own information. Unfortunately, however, secondary data didn't answer all the questions that Wow Wee was asking in this particular situation. To get these answers, the marketing team had to conduct primary research: they had to work directly with members of their target market. It's a challenging process. First, they had to decide exactly *what* they wanted to know. Then they had to determine *whom* to ask. Finally, they had to pick the best *methods* for gathering information.

We know what they wanted to know—we've already listed the questions they asked themselves. As for whom to talk to, they randomly selected representatives from their target market. Now, they could have used a variety of tools for collecting information from these people, each of which has its advantages and disadvantages. To understand the marketing-research process fully, we need to describe the most common of these tools:

- *Surveys*. Sometimes marketers mail questionnaires to members of the target market. In Wow Wee's case, the questionnaire could have included photos of Robosapien. It's an effective way to reach people, but the process is time consuming and the response rate is generally low. Phoning people also takes a lot

of time, but a good percentage of people tend to respond. Unfortunately, you can't show them the product. Online surveys are easier to answer and get better response rates, and the site can link to pictures or even videos of Robosapien.

- *Personal interviews.* Though time consuming, personal interviews not only let you talk with real people but also let you demonstrate Robosapien. You can also clarify answers and ask open-ended questions.
- *Focus groups.* With a focus group, you can bring together a group of individuals (perhaps six to ten) and ask them questions. A trained moderator can explain the purpose of the group and lead the discussion. If sessions are run effectively, you can come away with valuable information about customer responses to both your product and your marketing strategy.

Wow Wee used focus groups and personal interviews because both approaches had the advantage of allowing people to interact with Robosapien. In particular, focus-group sessions provided valuable opinions about the product, proposed pricing, distribution methods, and promotion strategies. Management was pleased with the feedback and confident that the product would succeed.

Researching your target market is necessary before you launch a new product. But the benefits of marketing research don't extend merely to brand-new products. Companies also use it when they're deciding whether or not to refine an existing product or develop a new marketing strategy for an existing product. Kellogg's, for example, conducted online surveys to get responses to a variation on its Pop-Tarts brand—namely, Pop-Tarts filled with a mixture of traditional fruit filling and yogurt. Marketers had picked out four possible names for the product and wanted to know which one kids and mothers liked best. They also wanted to know what they thought of the product and its packaging. Both mothers and kids liked the new Pop-Tarts (though for different reasons) and its packaging, and the winning name for the product launched in the spring of 2011 was “Pop-Tarts Yogurt Blasts.” The online survey of 175 mothers and their children was conducted in one weekend by an outside marketing research group.²⁶⁵

Branding

Armed with positive feedback from their research efforts, the Wow Wee team was ready

for the next step: informing buyers—both consumers and retailers—about their product. They needed a brand—some word, letter, sound, or symbol that would differentiate their product from similar products on the market. They chose the brand name *Robosapien*, hoping that people would get the connection between *Homo sapiens* (the human species) and *Robosapien* (the company’s coinage for its new robot “species”). To prevent other companies from coming out with their own “Robosapiens,” they took out a trademark by registering the name with the U.S. Patent and Trademark Office. Though this approach—giving a unique brand name to a particular product—is a bit unusual, it isn’t unprecedented. Mattel, for example, established a separate brand for Barbie, and Anheuser-Busch sells beer under the brand name Budweiser. Note, however, that the more common approach, which is taken by such companies as Microsoft, Dell, and Apple, calls for marketing all the products made by a company under the company’s brand name.

Branding Strategies

Companies can adopt one of three major strategies for branding a product:

1. With private branding (or *private labeling*), a company makes a product and sells it to a retailer who in turn resells it under its own name. A soft-drink maker, for example, might make cola for Wal-Mart to sell as its Sam’s Choice Cola house brand.
2. With generic branding, the maker attaches no branding information to a product except a description of its contents. Customers are often given a choice between a brand-name prescription drug or a cheaper generic drug with a similar chemical makeup.
3. With manufacturer branding, a company sells one or more products under its own brand names. Adopting a *multiproduct-branding* approach, it sells all its products under one brand name (generally the company name). Using a *multibranding* approach, it will assign different brand names to different products. Campbell’s Soup, which markets all its soups under the company’s name, uses the multiproduct-branding approach. Automakers generally use multibranding. Toyota, for example, markets to a wide range of potential customers by offering cars under various brand names (Toyota, Lexus, and Scion).

Building Brand Equity

Wow Wee went with the multibranding approach, deciding to market Robosapien under the robot's own brand name. Was this a good choice? The answer depends, at least in part, on how the product sells. If customers don't like Robosapien, its failure won't reflect badly on Wow Wee's other products. On the other hand, people might like Robosapien but have no reason to associate it with other Wow Wee products. In this case, Wow Wee wouldn't gain much from its brand equity—any added value generated by favorable consumer experiences with Robosapien. To get a better idea of how valuable brand equity is, think for a moment about the effect of the name *Dell* on a product. When you have a positive experience with a Dell product—say, a laptop or a printer—you come away with a positive opinion of the entire Dell product *line* and will probably buy more Dell products. Over time, you may even develop brand loyalty: you may prefer—or even insist on—Dell products. Not surprisingly, brand loyalty can be extremely valuable to a company. Because of customer loyalty, the value of the Coca-Cola brand is estimated at more than \$70 billion, followed by IBM at \$65 billion, Microsoft at \$61 billion, and Google at \$43 billion.²⁶⁶

Packaging and Labeling

Packaging—the container that holds your product—can influence a consumer's decision to buy a product or pass it up. Packaging gives customers a glimpse of the product, and it should be designed to attract their attention. Labeling—what you say about the product on your packaging—not only identifies the product but also provides information on the package contents: who made it and where or what risks are associated with it (such as being unsuitable for small children).

How has Wow Wee handled the packaging and labeling of Robosapien? The robot is fourteen inches tall, and it's almost as wide. It's also fairly heavy (about seven pounds), and because it's made out of plastic and has movable parts, it's breakable. The easiest, and least expensive, way of packaging it would be to put it in a square box of heavy cardboard and pad it with Styrofoam. This arrangement would not only protect the product from damage during shipping but also make the package easy to store. Unfortunately, it would also eliminate any customer contact with the product inside the box (such as seeing what it looks like and what it's made of). Wow Wee, therefore, packages Robosapien in a container that is curved to his shape and has a clear plastic front that allows people to see

the whole robot. It's protected during shipping because it is wired to the box. Why did Wow Wee go to this much trouble and expense? Like so many makers of so many products, it has to market the product while it's still in the box. Because he's in a custom-shaped see-through package, you tend to notice Robosapien (who seems to be looking at you) while you are walking down the aisle of the store.

Meanwhile, the labeling on the package details some of the robot's attributes. The name is highlighted in big letters above the descriptive tagline "A fusion of technology and personality." On the sides and back of the package are pictures of the robot in action with such captions as "Dynamic Robotics with Attitude" and "Awesome Sounds, Robo-Speech & Lights." These colorful descriptions are conceived to entice the consumer to make a purchase because its product features will satisfy some need or want.

Packaging can serve many purposes. The purpose of the Robosapien package is to attract your attention to the product's features. For other products, packaging serves a more functional purpose. Nabisco, for example, packages some of its tastiest snacks—Oreos, Chips Ahoy, and Lorna Doone's—in "100 Calorie Packs" that deliver exactly one hundred calories per package.²⁶⁷ Thus, the packaging itself makes life simpler for people who are keeping track of calories (and reminds them of how many cookies they can eat without exceeding one hundred calories).

Key Takeaways

- Developing and implementing a marketing program involves a combination of tools called the marketing mix (often referred to as the "four Ps" of marketing): product, price, place, and promotion.
- Before settling on a marketing strategy, marketers often do **marketing research** to collect and analyze relevant data.
- First, they look at **secondary data** that have already been collected, and then they collect new data, called **primary data**.
- Methods for collecting primary data include surveys, personal interviews, and **focus groups**.

- A **brand** is a word, letter, sound, or symbol that differentiates a product from its competitors.
- To protect a brand name, the company takes out a **trademark** by registering it with the U.S. Patent and Trademark Office.
- There are three major branding strategies:
 1. With **private branding**, the maker sells a product to a retailer who resells it under its own name.
 2. Under **generic branding**, a no-brand product contains no identification except for a description of the contents.
 3. Using **manufacture branding**, a company sells products under its own brand names.
- When consumers have a favorable experience with a product, it builds **brand equity**. If consumers are loyal to it over time, it enjoys **brand loyalty**.
- **Packaging**—the container holding the product—can influence consumers' decisions to buy products or not buy them. It offers them a glimpse of the product and should be designed to attract their attention.
- **Labeling**—the information on the packaging—identifies the product. It provides information on the contents, the manufacturer, the place where it was made, and any risks associated with its use.

Pricing a Product

Learning Outcome

1. Identify pricing strategies that are appropriate for new and existing products.

The second of the four Ps in the marketing mix is price. Pricing a product involves a certain amount of trial and error because there are so many factors to consider. If you price too high, a lot of people simply won't buy your product. Or you might find yourself facing competition from some other supplier that thinks it can beat your price. On the other hand, if you price too low, you might not make enough profit to stay in business. So how do you decide on a price? Let's look at several pricing options that were available to those marketers at Wow Wee who were responsible for pricing Robosapien. We'll begin by

discussing two strategies that are particularly applicable to products that are being newly introduced.

New Product Pricing Strategies

When Robosapien was introduced into the market, it had little direct competition in its product category. True, there were some “toy” robots available, but they were not nearly as sophisticated. Sony offered a pet dog robot called Aibo, but its price tag of \$1,800 was really high. Even higher up the price-point scale was the \$3,600 iRobi robot made by the Korean company Yujin Robotics to entertain kids and even teach them foreign languages. Parents could also monitor kids’ interactions with the robot through its own video-camera eyes; in fact, they could even use the robot itself to relay video messages telling kids to shut it off and go to sleep.²⁶⁸

Skimming and Penetration Pricing

Because Wow Wee was introducing an innovative product in an emerging market with few direct competitors, it considered one of two pricing strategies:

1. With skimming pricing, Wow Wee would start off with the highest price that keenly interested customers would pay. This approach would generate early profits, but when competition enters—and it will, because healthy profits can be made in the market—Wow Wee would have to lower its price.
2. Using penetration pricing, Wow Wee would initially charge a low price, both to discourage competition and to grab a sizable share of the market. This strategy might give the company some competitive breathing room (potential competitors won’t be attracted to low prices and modest profits). Over time, as its growing market discourages competition, Wow Wee could push up its prices.

Other Pricing Strategies

In their search for the best price level, Wow Wee’s marketing managers could consider a variety of other approaches, such as *cost-based pricing*, *demand-based pricing*, *target costing*, *odd-even pricing*, and *prestige pricing*. Any of these methods could be used not only to set an initial price but also to establish long-term pricing levels.

Before we examine these strategies, let’s pause for a moment to think about the pricing

decisions that you have to make if you're selling goods for resale by retailers. Most of us think of price as the amount that we—consumers—pay for a product. But when a manufacturer (such as Wow Wee) sells goods to retailers, the price it gets is *not* what we the consumers will pay for the product. In fact, it's a lot less.

Here's an example. Say you buy a shirt at a store in the mall for \$40. The shirt was probably sold to the retailer by the manufacturer for \$20. The retailer then marks up the shirt by 100 percent, or \$20, to cover its costs and to make a profit. The \$20 paid to the manufacturer plus the \$20 markup results in a \$40 sales price to the consumer.

Cost-Based Pricing

Using cost-based pricing, Wow Wee's accountants would figure out how much it costs to make Robosapien and then set a price by adding a profit to the cost. If, for example, it cost \$40 to make the robot, Wow Wee could add on \$10 for profit and charge retailers \$50.

Demand-Based Pricing

Let's say that Wow Wee learns through market research how much people are willing to pay for Robosapien. Following a demand-based pricing approach, it will use this information to set the price that it charges retailers. If consumers are willing to pay \$120 retail, Wow Wee will charge retailers a price that will allow retailers to sell the product for \$120. What would that price be? Here's how we would arrive at it: \$120 consumer selling price minus a \$60 markup by retailers means that Wow Wee can charge retailers \$60.

Target Costing

With target costing, you work backward. You figure out (again using research findings) how much consumers are willing to pay for a product. You then subtract the retailer's profit. From this price—the selling price to the retailer—you subtract an amount to cover your profit. This process should tell you how much you can spend to make the product. For example, Wow Wee determines that it can sell Robosapien to retailers for \$70. The company decides that it wants to make \$15 profit on each robot. Thus, Wow Wee can spend \$55 on the product (\$70 selling price to the retailer minus \$15 profit means that the company can spend \$55 to make each robot).

Prestige Pricing

Some people associate a high price with high quality—and, in fact, there generally is a

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correlation. Thus, some companies adopt a prestige-pricing approach—setting prices artificially high to foster the impression that they’re offering a high-quality product. Competitors are reluctant to lower their prices because it would suggest that they’re lower-quality products. Let’s say that Wow Wee finds some amazing production method that allows it to produce Robosapien at a fraction of its current cost. It could pass the savings on by cutting the price, but it might be reluctant to do so: What if consumers equate low cost with poor quality?

Odd-Even Pricing

Do you think \$9.99 sounds cheaper than \$10? If you do, you’re part of the reason that companies sometimes use odd-even pricing—pricing products a few cents (or dollars) under an even number. Retailers, for example, might price Robosapien at \$99 (or even \$99.99) if they thought consumers would perceive it as less than \$100.

Key Takeaways

- With a new product, a company might consider the **skimming approach**—starting off with the highest price that keenly interested customers are willing to pay. This approach yields early profits but invites competition.
- Using a **penetration approach**, marketers begin by charging a low price, both to keep out competition and to grab as much market share as possible.
- Several strategies work for existing as well as new products.
 - With **cost-based pricing**, a company determines the cost of making a product and then sets a price by adding a profit to the cost.
 - With **demand-based pricing**, marketers set the price that they think consumers will pay. Using **target costing**, they figure out how much consumers are willing to pay and then subtract a reasonable profit from this price to determine the amount that can be spent to make the product.

- Companies use **prestige pricing** to capitalize on the common association of high price and quality, setting an artificially high price to substantiate the impression of high quality.
- Finally, with **odd-even pricing**, companies set prices at such figures as \$9.99 (an odd amount), counting on the common impression that it sounds cheaper than \$10 (an even amount).

Placing a Product

Learning Outcomes

1. Explore various product-distribution strategies.
2. Explain how companies create value through effective supply chain management.

The next element in the marketing mix is *place*, which refers to strategies for *distribution*. Distribution entails all activities involved in getting the right quantity of your product to your customers at the right time and at a reasonable cost. Thus, distribution involves selecting the most appropriate *distribution channels* and handling the *physical distribution* of products.

Distribution Channels

Companies must decide how they will distribute their products. Will they sell directly to customers (perhaps over the Internet)? Or will they sell through an intermediary—a wholesaler or retailer who helps move products from their original source to the end user? As you can see from

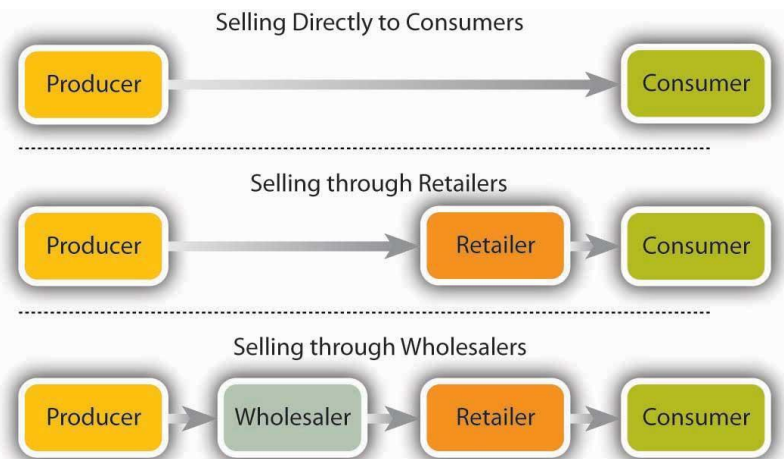


Figure 52 Distribution Channels

Figure 4 "Distribution Channels", various marketing channels are available to companies.

Figure 9.7 Distribution Channels

Selling Directly to Customers

Many businesses, especially small ones and those just starting up, sell directly to customers. Michael Dell, for example, started out selling computers from his dorm room. Tom First and Tom Story began operations at Nantucket Nectars by peddling home-brewed fruit drinks to boaters in Nantucket Harbor. Most service companies sell directly to their customers; it's impossible to give a haircut, fit contact lenses, mow a lawn, or repair a car through an intermediary. Many business-to-business sales take place through direct contact between producer and buyer. Toyota, for instance, buys components directly from suppliers.

The Internet has greatly expanded the number of companies using direct distribution, either as their only distribution channel or as an additional means of selling. Dell sells only online, while Adidas and Apple sell both on Web sites and in stores. The eBay online auction site has become the channel of choice for countless small businesses. Many of the companies selling over the Internet are enjoying tremendous sales growth. The largest of the online retailers—Amazon—was founded by Jeff Bezos in 1995 as an online bookstore. In its fifteen-plus years in business, the company has experienced tremendous success, generating more than \$34 billion in revenues during 2010. With sales soaring by 51 percent, the future looks bright for the company.²⁶⁹

The advantage of this approach of selling direct to the customer is a certain degree of control over prices and selling activities: you don't have to depend on or pay an intermediary. On the other hand, you must commit your own resources to the selling process, and that strategy isn't appropriate for all businesses. It would hardly be practical for Wow Wee to sell directly to individual consumers scattered around the world.

Selling through Retailers

Retailers buy goods from producers and sell them to consumers, whether in stores, by phone, through direct mailings, or over the Internet. Best Buy, for example, buys Robosapiens from Wow Wee and sells them to customers in its stores. Moreover, it promotes Robosapiens to its customers and furnishes technical information and assistance. Each Best Buy outlet features a special display at which customers can examine Robosapien and even try it out. On the other hand, selling through retailers

means giving up some control over pricing and promotion. The wholesale price you get from a retailer, who has to have room to mark up a retail price, is substantially lower than you'd get if you sold directly to consumers.

Selling through Wholesalers

Selling through retailers works fine if you're dealing with only a few stores (or chains). But what if you produce a product—bandages—that you need to sell through thousands of stores, including pharmacies, food stores, and discount stores. You'll also want to sell to hospitals, day-care centers, and even college health centers. In this case, you'd be committing an immense portion of your resources to the selling process. Besides, buyers like the ones you need don't want to deal

directly with you. Imagine a chain like CVS Pharmacy negotiating sales transactions with the maker of every single product that it carries in its stores. CVS deals with wholesalers (sometimes called *distributors*): intermediaries who buy goods from suppliers and sell them to businesses that will either resell or use them. Likewise, you'd sell your bandages to a wholesaler of health care products, which would, in turn, sell them both to businesses like CVS, Kmart, and Giant Supermarkets and to institutions, such as hospitals and college health care centers. The wholesaler doesn't provide this service for free. Here's how it works. Let's say that CVS is willing to pay \$2 a box for your bandages. If you go through a wholesaler, you'll probably get only \$1.50 a box. In other words, you'd make \$0.50 less on each box sold. Your profit margin—the amount you earn on each box—would therefore be less.

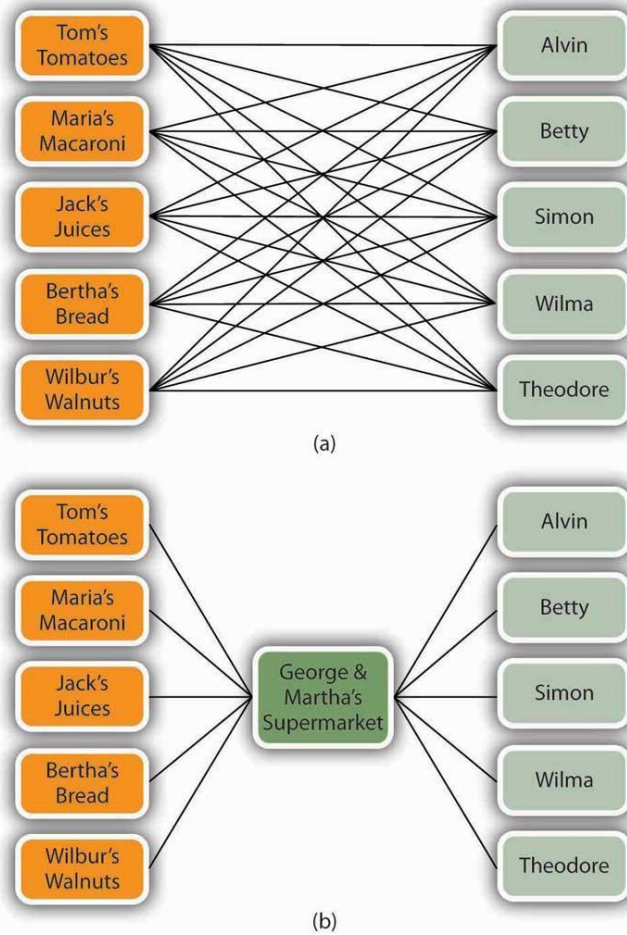


Figure 53 What an Intermediary Can Do

While selling through wholesalers will cut into your profit margins, the practice has several advantages. For one thing, wholesalers make it their business to find the best outlets for the goods in which they specialize. They're often equipped to warehouse goods for suppliers and to transport them from the suppliers' plants to the point of final sale. These advantages would appeal to Wow Wee. If it sold Robosapien's to just a few retailers, it wouldn't need to go through a distributor. However, the company needs wholesalers to supply an expanding base of retailers who want to carry the product. Finally, intermediaries, such as wholesalers, can make the distribution channel more cost-effective. Look, for example, at Figure 5 "What an Intermediary Can Do". Because every contact between a producer and a consumer incurs costs, the more contacts in the process (panel *a*), the higher the overall costs to consumers. The presence of an intermediary substantially reduces the total number of contacts (panel *b*).

Physical Distribution

Buyers from the stores that sell Robosapiens don't go to the Wow Wee factory (which happens to be in China) to pick up their orders. The responsibility for getting its products to customers, called physical distribution, belongs to Wow Wee itself. To keep its customers satisfied, Wow Wee must deliver robots on time, in good shape, and in the quantity ordered. To accomplish this, Wow Wee must manage several interrelated activities: *warehousing, materials handling, and transportation.*

Warehousing

After the robots have been packaged, they're ready for sale. It would be convenient if they've already been sold and only needed to be shipped to customers, but business-to-business (B2B) transactions don't always work out this way. More often, there's a time lag between manufacture and delivery. During this period, the robots must be stored somewhere. If Wow Wee has to store a large volume over an extended period (perhaps a month or two right before the holiday season), it will keep unsold robots in a storage warehouse. On the other hand, if Wow Wee has to hold them only temporarily while they're en route to their final destinations, they'll be kept in a distribution center. Wal-Mart, for example, maintains forty regional U.S. distribution centers at which it receives goods purchased from suppliers, sorts them, and distributes them to 4,400 stores, superstores, and Sam's Clubs around the country.²⁷⁰ Its efficiency in moving goods to its stores is a

major factor in Wal-Mart's ability to satisfy customer needs. How major? "The misconception," says one senior executive "is that we're in the retail business, but in reality, we're in the distribution business."²⁷¹

Materials Handling

Making, storing, and distributing Robosapien entails a good deal of materials handling—the process of physically moving or carrying goods during production, warehousing, and distribution. Someone (or some machine) needs to move both the parts that go into Robosapien and the partially finished robot through the production process. In addition, the finished robot must be moved into storage facilities and, after that, out of storage and onto a truck, plane, train, or ship. At the end of this leg of the trip, it must be moved into the store from which it will be sold.

Automation

All these activities draw on company resources, particularly labor, and there's always the risk of losing money because the robot's been damaged during the process. To sell goods at competitive prices, companies must handle materials as efficiently and inexpensively as possible. One way is by automating the process. For example, parts that go into the production of BMWs are stored and retrieved through automated sequencing centers.²⁷² Cars are built on moving assembly lines made of "skillets" large enough to hold workers who move along with the car while it's being assembled. Special assistors are used to help workers handle heavy parts. For hard-to-reach areas under the car, equipment rotates the car 90 degrees and sets the undercarriage at waist level. Records on each car's progress are updated by means of a bar code that's scanned at each stage of production.²⁷³

Just-in-Time Production

Another means of reducing materials-handling costs is called just-in-time production. Typically, companies require suppliers to deliver materials to their facilities *just in time* for them to go into the production process. This practice cuts the time and cost entailed by moving raw materials into and out of storage.

Transportation

There are several ways to transport goods from manufacturing facilities to resellers or customers—trucks, trains, planes, ships, and even pipelines. Companies select the best

mode (or combination of modes) by considering several factors, including cost, speed, match of transport mode to type of good, dependability, and accessibility. The choice usually involves trade-offs. Planes, for example, are generally faster but cost more than other modes. Sending goods by cargo ship or barge is inexpensive but very slow (and out of the question if you want to send something from Massachusetts to Chicago). Railroads are moderately priced, generally accessible, and faster than ships but slower than planes. They're particularly appropriate for some types of goods, such as coal, grain, and bulky items (such as heavy equipment and cars). Pipelines are fine if your product happens to be petroleum or natural gas. Trucks, though fairly expensive, work for most goods and can go just about anywhere in a reasonable amount of time.

According to the U.S. Department of Transportation,²⁷⁴ trucks are the transportation of choice for most goods, accounting for 65 percent of U.S. transportation expenditures. Trucks also play an important role in the second highest category—multimodal combinations, which account for 11 percent of expenditures. *Multimodal combinations* include rail and truck and water and truck. New cars, for example, might travel from Michigan to California by rail and then be moved to tractor trailers to complete their journey to dealerships. Water accounts for 9 percent of expenditures, air for 8 percent. When used alone, rail accounts for only 4 percent but is commonly combined with other modes. Pipelines account for 3 percent of expenditures. Crowded highways notwithstanding, the economy would come to a standstill without the two million workers that make up the U.S. trucking industry.²⁷⁵

Creating an Effective Distribution Network: The Supply Chain

Before we go on to the final component in the marketing mix—*promotion*—let's review the elements that we've discussed so far: product, price, and place. As we've seen, to be competitive, companies must produce quality products, sell them at reasonable prices, and make them available to customers at the right place at the right time. To accomplish these three tasks, they must work with a network of other firms, both those that supply them with materials and services and those that deliver and sell their products. To better understand the links that must be forged to create an effective network, let's look at the steps that the candy maker Just Born takes to produce and deliver more than one billion Marshmallow Peeps each year to customers throughout the world. Each day, the company engages in

the following process:

- Purchasing managers buy raw materials from suppliers (sugar and other ingredients used to make marshmallow, food coloring, and so forth).
- Other operations managers transform these raw materials, or ingredients, into 4.2 million Marshmallow Peeps every day.
- Operations managers in shipping send completed packages to a warehouse where they're stored for later distribution.
- Operations managers at the warehouse forward packaged Marshmallow Peeps to dealers around the world.
- Retail dealers sell the Marshmallow Peeps to customers.

This process requires considerable cooperation not only among individuals in the organization but also between Just Born and its suppliers and dealers. Raw-materials suppliers, for instance, must work closely with Just Born purchasing managers, who must, in turn, work with operations managers in manufacturing at Just Born itself. People in manufacturing have to work with operations managers in the warehouse, who have to work with retail dealers, who have to work with their customers.

If all the people involved in each of these steps worked independently, the process of turning raw materials into finished Marshmallow Peeps and selling them to customers would be inefficient (to say the least). However, when everyone works in a coordinated manner, all parties benefit. Just Born can make a higher-quality product at a lower cost because it knows that it's going to get cooperation from suppliers whose livelihood, after all, depends on the success of customers like Just Born: suppliers can operate more efficiently because they can predict the demand for their products (such as sugar and food coloring). At the other end of the chain, dealers can operate efficiently because they can depend on Just Born to deliver a quality product on time. The real beneficiary is ultimately the end user, or customer: because the process that delivers the product is efficient, its costs are minimized and its quality is optimized. The customer, in other words, gets a higher-quality product at a lower price.

Supply Chain Management

As you can see in Figure 6 "A Simplified Supply Chain", the flow that begins with the

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purchase of raw materials and culminates in the sale of the Marshmallow Peeps to end users is called the supply chain. The process of integrating all the activities in the supply chain is called supply chain management (SCM). As you can see from our discussion so far, SCM requires a high level of cooperation among the members of the chain. All parties must be willing to share information and work together to maximize the final customer's satisfaction.²⁷⁶

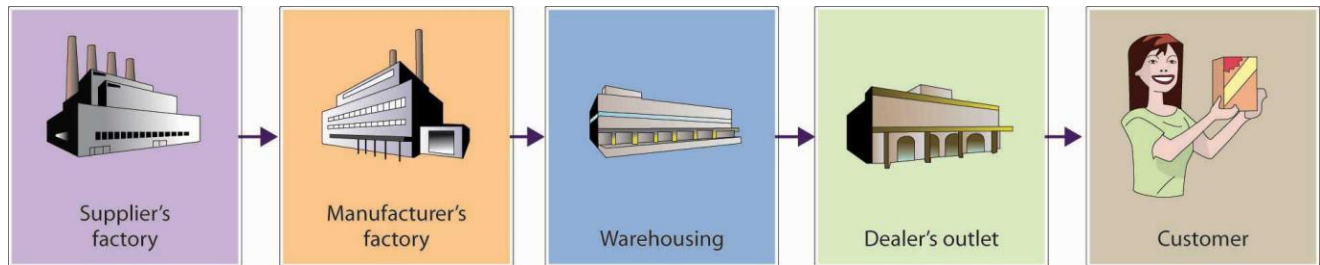


Figure 54 A Simplified Supply Chain

Managing your supply chain can be difficult, particularly if your company has large seasonal fluctuations.²⁷⁷ This is certainly true at Just Born. Even though it has a Marshmallow Peep for every season (heart Peeps for Valentine's Day, spooky Peeps for Halloween, patriotic Peeps for July Fourth, and so on), the biggest problem rests with the standard yellow Marshmallow Peep that provides a major spike in sales each spring. Without careful supply chain management, there would be either too many or too few yellow Marshmallow Peeps—both big problems. To reduce the likelihood of either situation, the manager of the company's supply chain works to ensure that all members of the chain work together throughout the busy production season, which begins each fall. Suppliers promise to deliver large quantities of ingredients, workers recognize that they will be busy through February, and dealers get their orders in early. Each member of the chain depends on the others to meet a mutually shared goal: getting the right quantity of yellow Marshmallow Peeps to customers at the right time.

But what if a company has multiple sales spikes (and lulls)? What effect does this pattern have on its supply chain? Consider Domino's Pizza. Have you ever thought about what it takes to ensure that a piping-hot pizza will arrive at your door on Super Bowl Sunday (Domino's busiest day of the year)? What about on the average weekend? How about when the weather's bad and you just don't want to go out? Clearly, Domino needs a finely

tuned supply chain to stay on top of demand. Each year, the company sells about four hundred million pizzas (more than one pizza for every man, woman, and child in the United States). Its suppliers help to make this volume possible by providing the company with about one hundred fifty million pounds of cheese and toppings. Drivers do their part by logging nine million miles a week (the equivalent of 37.5 round trips to the moon every week).

How are these activities managed? Dominos relies on a software system that uses historical data to forecast demand by store; determines, orders, and adjusts supplies; fills staffing needs according to expected sales levels; and facilitates the smooth flow of accurate information among members of the chain. All this coordination is directed at a single goal—satisfying the largest possible number of end users.²⁷⁸

The Value Chain

Supply chain management helps companies produce better products at lower costs and to distribute them more effectively. Remember, however, that effective supply chain management doesn't necessarily guarantee success. A company must also persuade consumers to buy its products, rather than those of its competitors, and the key to achieving this goal is delivering the most value.

The Customer Value Triad

Today's consumers can choose from a huge array of products offered at a range of prices through a variety of suppliers. So how do they decide which product to buy? Most people buy the product that gives them the highest value, and they usually determine value by considering the three factors that many marketers call the customer value triad: *quality*, *service*, and *price*.²⁷⁹ In short, consumers tend to select the product that provides the best combination of these factors.

To deliver high customer value, a company must monitor and improve its value chain—the entire range of activities involved in delivering value to customers.²⁸⁰ Some of these activities arise in the process of supply chain management—obtaining raw materials, manufacturing products, getting finished goods to customers. Others take place outside the supply chain, particularly those associated with marketing and selling products and with providing customer support. In addition, companies need to find ways of creating

value by improving the internal operations—procurement, research and development, human resource management, and financial management—that support their primary value-chain activities.

The idea is fairly simple: by focusing on the interrelated links in its value chain, a company can increase product quality, provide better service, and cut prices. In other words, it can improve its quality-service-price mix, thereby making its products more competitive.

Key Takeaways

- **Distribution** entails all activities involved in getting the right quantity of a product to customers at the right time and at a reasonable cost.
- Companies can sell directly (from stores or over the Internet) or indirectly, through **intermediaries**—retailers or wholesalers who help move products from producers to end users.
- **Retailers** buy goods from producers and sell them to consumers, whether in stores, by phone, through direct mailings, or over the Internet.
- **Wholesalers** (or distributors) buy goods from suppliers and sell them to businesses that will resell or use them.
- **Physical distribution**—the process of getting products from producers to customers—entails several interrelated activities: *warehousing* in either a **storage warehouse** or a **distribution center**, **materials handling** (physically moving products or components), and *transportation* (shipping goods from manufacturing facilities to resellers or customers).
- A firm can produce better-quality products at lower cost and distribute them more effectively by successfully managing its **supply chain**—the entire range of activities involved in producing and distributing products, from purchasing raw materials, transforming raw materials into finished goods, storing finished goods, and distributing them to customers.

- Effective **supply chain management (SCM)** requires cooperation, not only among individuals within the organization but also among the company and its suppliers and dealers. In addition, a successful company provides customers with added value by focusing on and improving its **value chain**—the entire range of its value-creating activities.

Promoting a Product

Learning Outcome

1. Describe the elements of the promotion mix.

Your promotion mix—the means by which you communicate with customers—may include advertising, personal selling, sales promotion, and publicity. These are all tools for telling people about your product and persuading potential customers, whether consumers or organizational users, to buy it. Before deciding on an appropriate promotional strategy, you should consider a few questions:

- What’s the main purpose of the promotion? Am I simply trying to make people aware of my product, or am I trying to get people to buy it right now? Am I trying to develop long-term customers? Am I trying to connect with my current customers? Am I trying to promote my company’s image?
- What’s my target market? What’s the best way to reach it?
- Which product features (quality, price, service, availability, innovativeness) should I emphasize? How does my product differ from those of competitors?
- How much can I afford to invest in a promotion campaign?
- How do my competitors promote their products? Should I take a similar approach?

To promote a product, you need to imprint a clear image of it in the minds of your target audience. What do you think of, for instance, when you hear “Ritz-Carlton”? What about “Motel 6”? They’re both hotel chains, but the names certainly conjure up different images. Both have been quite successful in the hospitality industry, but they project very different images to appeal to different clienteles. The differences are evident in their promotions.

The Ritz-Carlton Web site describes “luxury hotels” and promises that the chain provides “the finest personal service and facilities throughout the world.”²⁸¹ Motel 6, by contrast, characterizes its facilities as “discount hotels” and assures you that you’ll pay “discount hotel rates.”²⁸²

Promotional Tools

We’ll now examine each of the elements that can go into the promotion mix—*advertising*, *personal selling*, *sales promotion*, and *publicity*. Then we’ll see how Wow Wee incorporated them into a promotion mix to create a demand for Robosapien.

Advertising

Advertising is paid, non-personal communication designed to create an awareness of a product or company. Ads are everywhere—in print media (such as newspapers, magazines, the *Yellow Pages*), on billboards, in broadcast media (radio and TV), and on the Internet. It’s hard to escape the constant barrage of advertising messages; indeed, it’s estimated that the average consumer is confronted by about five thousand ad messages each day (compared with about five hundred ads a day in the 1970s).²⁸³ For this very reason, ironically, ads aren’t as effective as they used to be. Because we’ve learned to tune them out, companies now have to come up with innovative ways to get through to potential customers. A *New York Times* article²⁸⁴ claims that “anywhere the eye can see, it’s likely to see an ad.” Subway turnstiles are plastered with ads for GEICO auto insurance, Chinese food containers are decorated with ads for Continental Airways, parking meters display ads for Campbell’s Soup,²⁸⁵ examining tables in pediatricians’ offices are covered with ads for Disney’s *Little Einsteins* DVDs, school buses play radio ads for children, “Got Milk” billboards at San Francisco bus stops give off the smell of chocolate chip cookies, and U.S. Airways is even selling ads on motion sickness bags (yuck!).²⁸⁶ Even so, advertising is still the most prevalent form of promotion.

Your choice of advertising media depends on your product, your target audience, and your budget. A travel agency selling spring-break getaways to college students might post flyers on campus bulletin boards or run ads in campus newspapers. A pharmaceutical company trying to develop a market for a new allergy drug might focus on TV ads that reach a broad audience of allergy sufferers. A fitness center might purchase a Google ad that appears

next to the search results when someone puts in a relevant keyword, such as fitness. A small hot dog and hamburger stand will probably spend its limited advertising budget on ads in the *Yellow Pages* and local newspapers (or pay a broke college student to stand by the side of the road dressed in a hot dog costume and hold a sign that entices potential customers to “come on in”). The cofounders of Nantucket Nectars found radio ads particularly effective. Rather than pay professionals, they produced their own ads themselves. (Actually, they just got on the radio and started rambling about their product or their lives or anything else that seemed interesting at the time.)²⁸⁷ As unprofessional as they sounded, the ads worked, and the business grew.

Personal Selling

Personal selling refers to one-on-one communication with customers or potential customers. This type of interaction is necessary in selling large-ticket items, such as homes, and it’s also effective in situations in which personal attention helps to close a sale, such as sales of cars and insurance policies.

Many retail stores depend on the expertise and enthusiasm of their salespeople to persuade customers to buy. Home Depot has grown into a home-goods giant in large part because it fosters one-on-one interactions between salespeople and customers. The real difference between Home Depot and everyone else, says one of its cofounders, isn’t the merchandise; it’s the friendly, easy-to-understand advice that salespeople give to novice homeowners. Customers who never thought they could fix anything suddenly feel empowered to install a carpet or hang wallpaper.²⁸⁸ “Congratulations! You can spend two free nights at any Hyatt Hotel in the world! All you have to do is sign up for a Hyatt-branded credit card.”²⁸⁹ This tactic is a form of sales promotion in which a company provides an incentive for a potential customer to buy something. Most sales promotions are more straightforward than our hotel stay/credit-card offer. Promotional giveaways might feature free samples or money-off coupons. Promotions can involve in-store demonstrations or trade-show displays. They can be cheaper than advertising and can encourage customers to buy something quickly.

Apple Inc. and Starbucks partner to promote the iTunes experience by giving away free iTunes products, including a “Pick of the Week” music download, apps, book samples from

the iBookstore, TV shows, and games. The current app giveaway is the Shazam Encore App, a music recognition service that allows users to immediately identify any song that's playing, see the lyrics, watch the music videos, purchase concert tickets, and buy the track and share it with friends on Facebook and Twitter. The joint promotion benefits both companies: Apple gets to plug its iTunes download and other products, and Starbucks entices customers to come into its stores, enjoy free Wi-Fi, and buy coffee.²⁹⁰

Publicity and Public Relations

Free publicity—say, getting your company or your product mentioned in a newspaper or on TV—can often generate more customer interest than a costly ad. You may remember the holiday season buying frenzy surrounding a fuzzy red doll named “Tickle Me Elmo.” The big break for this product came when the marketing team sent a doll to the one-year-old son of talk-show host Rosie O’Donnell. Two months before Christmas, O’Donnell started tossing dolls into the audience every time a guest said the word *wall*. The product took off, and the campaign didn’t cost marketers anything except a few hundred dolls.²⁹¹

Consumer perception of a company is often important to a company’s success. Many companies, therefore, manage their public relations in an effort to garner favorable publicity for themselves and their products. When the company does something noteworthy, such as sponsoring a fund-raising event, the public relations department may issue a press release to promote the event. When the company does something negative, such as selling a prescription drug that has unexpected side effects, the public relations department will work to control the damage to the company. Each year, the accounting firm of PricewaterhouseCoopers and the *Financial Times* jointly survey more than a thousand CEOs in twenty countries to identify companies that have exhibited exceptional integrity or commitment to corporate governance and social responsibility. Among the companies circulating positive public relations as a result of a survey were General Electric, Microsoft, Coca-Cola, and IBM.²⁹²

Marketing Robosapien

Now let’s look more closely at the strategy that Wow Wee pursued in marketing Robosapien in the United States. The company’s goal was ambitious: to promote the robot as a must-have item for kids of all ages. As we know, Wow Wee intended to position

Robosapien as a home-entertainment product, not as a toy. The company rolled out the product at Best Buy, which sells consumer electronics, computers, entertainment software, and appliances. As marketers had hoped, the robot caught the attention of consumers shopping for TV sets, DVD players, home and car audio equipment, music, movies, and games. Its \$99 price tag was also consistent with Best Buy's storewide pricing. Indeed, the retail price was a little lower than the prices of other merchandise, and that fact was an important asset: shoppers were willing to treat Robosapien as an *impulse item*—something extra to pick up as a gift or as a special present for children, as long as the price wasn't too high.

Meanwhile, Robosapien was also getting lots of free publicity. Stories appeared in newspapers and magazines around the world, including the *New York Times*, the *Times of London*, *Time* magazine, and *National Parenting* magazine. Commentators on *The Today Show*, *The Early Show*, CNN, ABC News, and FOX News remarked on it; it was even the talk of the prestigious New York Toys Fair. It garnered numerous awards, and experts predicted that it would be a hot item for the holidays.

At Wow Wee, Marketing Director Amy Weltman (who had already had a big hit with the Rubik's Cube) developed a gala New York event to showcase the product. From mid- to late August, actors dressed in six-foot robot costumes roamed the streets of Manhattan, while the fourteen-inch version of Robosapien performed in venues ranging from Grand Central Station to city bars. Everything was recorded, and film clips were sent to TV stations.

Then the stage was set for expansion into other stores. Macy's ran special promotions, floating a twenty-four-foot cold-air robot balloon from its rooftop and lining its windows with armies of Robosapien's. Wow Wee trained salespeople to operate the product so that they could help customers during in-store demonstrations. Other retailers, including The Sharper Image, Spencer's, and Toys "R" Us, carried Robosapien, as did e-retailers such as Amazon.com. The product was also rolled out (with the same marketing flair) in Europe and Asia.

When national advertising hit in September, all the pieces of the marketing campaign came together—publicity, sales promotion, personal selling, and advertising. Wow Wee

ramped up production to meet anticipated fourth-quarter demand and waited to see whether Robosapien would live up to commercial expectations.

Key Takeaways

- The **promotion mix**—the ways in which marketers communicate with customers includes all the tools for telling people about a product and persuading potential customers to buy it.
- **Advertising** is paid, non-personal communication designed to create awareness of a product or company.
- **Personal selling** is one-on-one communication with existing and potential customers.
- **Sales promotions** provide potential customers with direct incentives to buy.
- **Publicity** involves getting the name of the company or its products mentioned in print or broadcast media.

The Product Life Cycle

Learning Outcome

1. Explain how a product moves through its life cycle and how this brings about shifts in marketing-mix strategies.

Did you play with LEGO blocks when you were a kid? Almost everyone did. They were a big deal. Store shelves were stacked with boxes of plastic bricks, wheels, and windows, plus packages containing just the pieces you needed to make something special, like a LEGO helicopter. McDonald's put LEGO sets in Happy Meals. If you walk down a toy-store aisle today, you'll still find LEGOs. They're shelved alongside



Figure 55 LEGO has decided to go back to basics and focus on the classic bricks rather than complicated kits.

the XBOX Kinect, Buzz Lightyear, and other playthings that appeal to contemporary kids. Like these products, they're more sophisticated. They're often tied in with movies, such as *Toy Story*, *Cars*, *Star Wars*, and *Harry Potter*.

Nowadays, the seventy-nine-year old Danish company is doing very well: in 2010, its sales rose 37 percent and profits were up 70 percent.²⁹³ The LEGO Group has moved its way up to the fifth largest toy company in the world based on sales.²⁹⁴ Things were very different seven years earlier—LEGO sales had declined drastically in the early 2000s. In its 2003 annual report, its CEO admitted that “2003 was a very disappointing year for LEGO Company.” Net sales fell by 26 percent, resulting in a loss in earnings for the year and significant decline in market share. LEGO planned to drop many of its recent initiatives and focus on its classic LEGO brick products.²⁹⁵

Let's look closer and find out what happened to the LEGO brand prior to its turnaround seven years ago. It was moving through stages of development and decline.²⁹⁶ Marketers

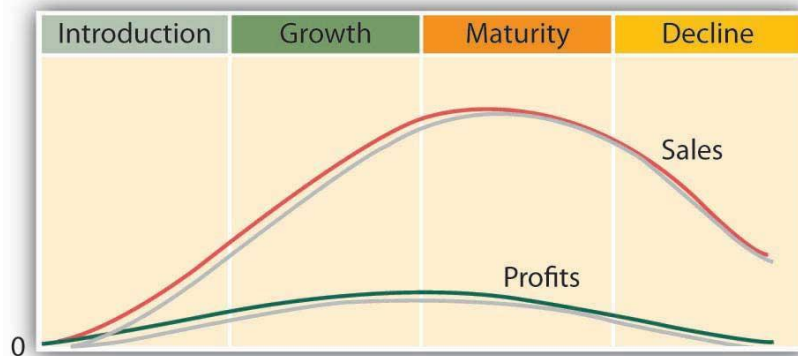


Figure 56 The Product Life Cycle

call this process the product life cycle, which is illustrated in Figure 8 "The Product Life Cycle". In theory, it's a lot like the life cycle that people go through. Once it's developed, a new product is *introduced* to the market. With any success at all, it begins to *grow*,

attracting more buyers. At some point, the market stabilizes, and the product becomes *mature*. Eventually, however, its appeal diminishes, and it's overtaken by competing brands or substitute products. Sales *decline*, and it's ultimately taken off the market.

This is a simplified version of the cycle. There are lots of exceptions to the product life-cycle rules. For one thing, most products never make it past the introduction stage; they die an early death. Second, some products (like some people) avoid premature demise by reinventing themselves. This is what the LEGO Group did. The company had been reinventing itself during the fifteen-year period of 1990 to 2005, launching new products in

an effort to recover its customer base and overcome a series of financial crises. Unfortunately, this strategy was unsuccessful. As pointed out by its CEO, the introduction of new products and the resulting costs “have not produced the desired results. In some cases,” admits the company, “new products have even cannibalized on the sales of LEGO Company’s core products and thus eroded earnings.”²⁹⁷

A take-over threat by Mattel Toy Company forced its CEO into action.²⁹⁸ His first step in formulating a resurrection plan was to fly to Virginia and attend a convention for adult fans of LEGO’s. The attendees’ stories of how LEGOs helped shape their minds gave him hope that the family-owned company could be saved. He returned to Denmark and put into place a plan that included downsizing the number of employees, selling its LEGOLAND theme parks, simplifying product designs, cutting unprofitable product lines, and focusing on what made the company great: LEGO building blocks.

Life Cycle and the Changing Marketing Mix

As a product or brand moves through its life cycle, the company that markets it will shift its marketing-mix strategies. Let’s see how the mix might be changed at each stage.

Introduction

At this stage, most companies invest in advertising to make consumers aware of a product. If it faces only limited competition, it might use a skimming-pricing approach. Typically, because it will sell only a relatively small quantity of the product, it will distribute through just a few channels. Because sales are low while advertising and other costs are high, the company tends to lose money during this stage.

Growth

As the company focuses on building sales, which are increasing rapidly at this stage, its advertising costs will go up. If competition appears, it may respond by lowering prices and distributing through multiple distribution channels. With sales going up and costs going down, the product becomes more profitable.

Maturity

If a product survives the growth stage, it will probably remain in the maturity stage for a long time. Sales still grow, though at a decreasing rate, and will eventually stabilize.

Advertising will be used to differentiate the product from competition. Price wars may

occur, but profits will be good because sales volume will remain high. As the product becomes outdated, the company may make changes in keeping with changing consumer preferences.

Decline

In 2004, LEGO was in this stage: demand had declined as more innovative products absorbed the attention of kids. Price competition had become more intense, and profits were harder to come by; in fact, in some years, they had turned into losses. But, unlike most products that enter the decline stage, LEGO avoided its likely demise by reinventing itself. Now, as the Danish phrase *leg godt*, from which the name LEGO was coined, suggests, children all over the world can take out their LEGOs and “play-well.”

Key Takeaways

- The stages of development and decline that products go through over their lives is called the **product life cycle**.
- The stages a product goes through are introduction, growth, maturity, and decline.
 1. Once it's developed, a new product is *introduced* to the market.
 2. With any success at all, it begins to *grow*, attracting more buyers.
 3. At some point the market stabilizes, and the product becomes *mature*.
 4. Eventually, its appeal diminishes, and it's overtaken by competing brands or substitute products. Sales *decline* and it's ultimately taken off the market.
- As a product moves through its life cycle, the company that markets it will shift its marketing-mix strategies.

The Marketing Environment

Learning Outcomes

1. Describe the external marketing environment in which businesses operate.
2. Discuss the factors that influence consumer behavior.

By and large, managers can control the four Ps of the marketing mix: they can decide

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which products to offer, what prices to charge for them, how to distribute them, and how to reach target audiences. Unfortunately, there are other forces at work in the marketing world—forces over which marketers have much less control. These forces make up a company’s external marketing environment, which, as you can see in Figure 9 "The Marketing Environment", we can divide into five sets of factors:

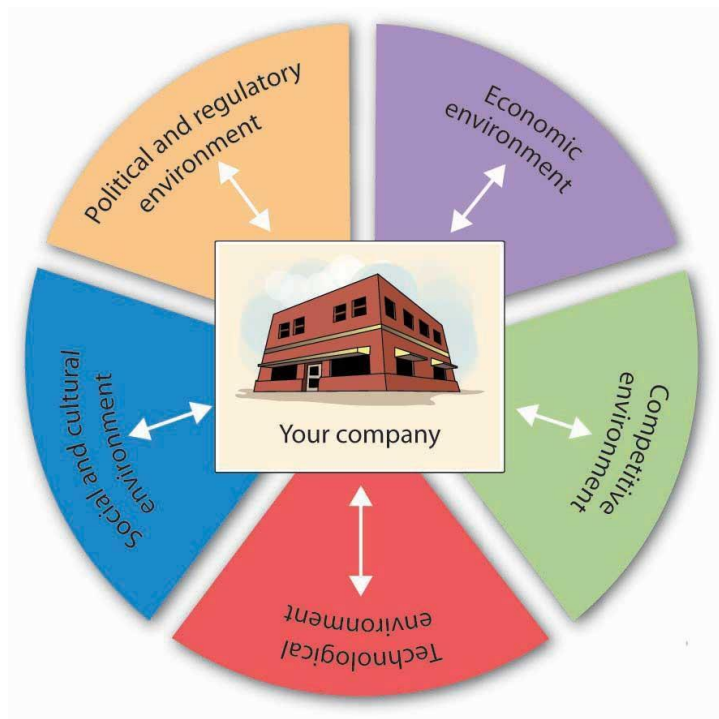


Figure 57 The Marketing Environment

1. Political and regulatory
2. Economic
3. Competitive
4. Technological
5. Social and cultural

These factors—and changes in them—present both threats and opportunities that require shifts in marketing plans. To spot trends and other signals that conditions may be in flux, marketers must continually monitor the environment in which their companies operate. To get a better idea of how they affect a firm’s marketing activities, let’s look at each of the five areas of the external environment.

The Political and Regulatory Environment

Federal, state, and local bodies can set rules or restrictions on the conduct of businesses. The purpose of regulation is to protect both consumers and businesses. Businesses favor some regulations (such as patent laws) while chafing under others (such as restrictions on advertising). The tobacco industry, for example, has had to learn to live with a federal ban on TV and radio advertising. More recently, many companies in the food industry have expressed unhappiness over regulations requiring the labeling of trans-fat content. The broadcasting industry is increasingly concerned about fines being imposed by the Federal Communications Commission for offenses against “standards of decency.” The loudest outcry probably came from telemarketers in response to the establishment of “do-not-call”

registries.

All these actions occasioned changes in the marketing strategies of affected companies. Tobacco companies rerouted advertising dollars from TV to print media. Food companies reduced trans-fat levels and began targeting health-conscious consumers. Talent coordinators posted red flags next to the names of Janet Jackson (of the now-famous malfunctioning costume) and other performers. The telemarketing industry fired workers and scrambled to reinvent its entire business model.

The Economic Environment

Every day, marketing managers face a barrage of economic news. They must digest it, assess its impact, and alter marketing plans accordingly. Sometimes (but not recently), the news is cause for optimism—the economy’s improving, unemployment’s declining, consumer confidence is up. At other times (like today), the news makes them nervous—our economy is weak, industrial production is down, jobless claims are rising, consumer confidence has plummeted, credit is hard to get. Naturally, business thrives when the economy is growing, employment is full, and prices are stable. Marketing products is easier because consumers are willing to buy. On the other hand, when the economy is slowing (or stalled) and unemployment is rising, people have less money to spend, and the marketer’s job is harder.

Then there’s inflation, which pushes interest rates upward. If you’re trying to sell cars, you know that people facing higher interest rates aren’t so anxious to take out car loans. Sales will slip, and to counteract the anticipated slowdown, you might have to add generous rebates to your promotional plans.

Moreover, if you operate in foreign markets, you can’t focus on solely domestic economic conditions: you have to monitor the economy in every region where you do business. For example, if you’re the marketing director for a U.S. company whose goods are manufactured in China and sold in Brazil, you’ll need to know as much as you can about the economies in three countries: the United States, China, and Brazil. For one thing, you’ll have to pay particular attention to fluctuations in exchange rates, because changes will affect both your sales and your profits.

The Competitive Environment

Imagine playing tennis without watching what your opponent was doing. Marketers who don't pay attention to their competitors are playing a losing game. In particular, they need to monitor the activities of two groups of competitors: the makers of competing brands and the makers of substitute products. Coke and Pepsi, for instance, are brand competitors who have engaged in the so-called cola wars for decades. Each tries to capture market share by convincing people that its soft drinks are better. Because neither wants to lose share to the other, they tend to resort to similar tactics. In summer 2004, both companies came out with nearly identical new colas boasting half the sugar, half the calories, and half the carbohydrates of regular colas. Coke called its product Coke C2, while Pepsi named its competing brand PepsiEdge. Both companies targeted cola drinkers who want the flavor of a regular soda but fewer calories. (By the way, both products failed and were taken off the market.)

Meanwhile, Coke and Pepsi have to watch Nantucket Nectars, whose fruit drinks are substitute products. What if Nantucket Nectars managed to get its drinks into the soda machines at more fast-food restaurants? How would Coke and Pepsi respond? What if Nantucket Nectars, which markets an ice tea with caffeine, introduced an ice tea drink with mega amounts of caffeine? Would marketers at Coke and Pepsi take action? What if Nantucket Nectars launched a marketing campaign promoting the health benefits of fruit drinks over soda? Would Coke and Pepsi reply with campaigns of their own? Would they respond by introducing new non-cola products?

The Technological Environment

When's the last time you rented a VHS tape of a new movie? If you had trouble finding it, that's because DVDs are in and videotapes are out. Videotape makers who were monitoring technological trends in the industry would probably have taken steps to keep up (go into DVDs) or otherwise protect themselves from losses (maybe even getting out of the market). In addition to making old products obsolete, technological advances create new products. Where would we be without the cell phone, digital cameras, text messaging, LASIK surgery, and global positioning systems?

New technologies also transform the marketing mix in another important way: they alter

the way companies market their products. Consider the revolutionary changes brought about by the Internet, which offers marketers a new medium for promoting and selling a vast range of goods and services. Marketers must keep abreast of technological advances and adapt their strategies, both to take advantage of the opportunities and to ward off threats.

The Social and Cultural Environment

Marketers also have to stay tuned to social and cultural factors that can affect sales. The values and attitudes of American consumers are in a state of almost constant flux; what's cool one year is out of style the next. Think about the clothes you wore five years ago: would you wear them today? A lot of people wouldn't—they're the wrong style, the wrong fit, the wrong material, the wrong color, or just plain wrong. Now put yourself in the place of a marketer for a clothing company that targets teenagers and young adults. You wouldn't survive if you tried to sell the same styles every year. As we said at the outset of this chapter, the key to successful marketing is meeting the needs of customers. This means knowing what they want right now, not last year.

Here's another illustration. The last few decades have witnessed monumental shifts in the makeup of the American workforce. The number of women at all levels has increased significantly, the workforce has become more diverse, and telecommuting is more common. More people place more importance on balancing their work lives with the rest of their lives, and fewer people are willing to sacrifice their health to the demands of hectic work schedules. With these changes have come new marketing opportunities. As women spend more time at work, the traditional duties of the "homemaker" have shifted to day-care centers, nannies, house-cleaning services, and (for those who can afford them) child chauffeurs, birthday-party coordinators, and even family-photo assemblers.²⁹⁹ The number of gyms has mushroomed, the selection of home office furniture has expanded, and McDonald's has bowed to the wishes of the health-conscious by eliminating its "super-size" option.

Generation Gaps

Clothiers who target teens and young adults (such as Gap and Abercrombie & Fitch) must estimate the size of both current and future audiences. So must companies that specialize

in products aimed at customers in other age brackets—say, young children or retirees. Marketers pay particular attention to population shifts because they can have dramatic effects on a consumer base, either increasing or decreasing the number of potential customers.

Marketers tend to assign most Americans born in the last sixty years to one of three groups: the *baby-boom generation* (those born between 1946 and 1964), *Generation X* (1965 to 1975), and *Generation Y*—also known as “echo baby boomers” or “millenniums” (1976 to 2001).³⁰⁰ In addition to age, members of each group tend to share common experiences, values, and attitudes that stay with them as they mature. These values and attitudes have a profound effect on both the products they want and the marketing efforts designed to sell products to them. Let’s look a little more closely at some of the defining characteristics of each group.

Baby Boomers

The huge wave of baby boomers began arriving in 1946, following World War II, and marketers have been catering to them ever since. What are they like? Sociologists have attributed to them such characteristics as “individuality, tolerance, and self-absorption.”³⁰¹ There are seventy million of them,³⁰² and as they marched through life over the course of five decades, marketers crowded the roadside to supply them with toys, clothes, cars, homes, and appliances—whatever they needed at the time. They’re still a major marketing force, but their needs have changed: they’re now the target market for Botox, pharmaceutical products, knee surgery, financial investments, cruises, vacation homes, and retirement communities.

Generation X

Because birth rates had declined by the time the “Gen X” babies first arrived in 1965, this group had just one decade to grow its numbers. Thus, it’s considerably smaller (seventeen million)³⁰³ than the baby-boomer group, and it has also borne the brunt of rising divorce rates and the arrival of AIDS. Experts say, however, that they’re diverse, savvy, and pragmatic³⁰⁴ and point out that even though they were once thought of as “slackers,” they actually tend to be self-reliant and successful. At this point in their lives, most are at their peak earning power and affluent enough to make marketers stand up and take notice.

Generation Y

When they became parents, baby boomers delivered a group to rival their own. Born between 1976 and 2001, their sixty million³⁰⁵ children are sometimes called “echo boomers” (because their population boom is a reverberation of the baby boom). They’re still evolving, but they’ve already been assigned some attributes: they’re committed to integrity and honesty, family oriented and close to parents, ethnically diverse and accepting of differences, upbeat and optimistic about the future (although the troubled economy is lessening their optimism), education focused, independent, and goal oriented.³⁰⁶ They also seem to be coping fairly well: among today’s teens, arrests, drug use, drunk driving, and school dropout rates are all down.³⁰⁷ Generation Ys are being courted by carmakers. Global car manufacturers have launched a number of 2012 cars designed to cater to the members of Generation Y.³⁰⁸ Advertisers are also busy trying to find innovative ways to reach this group, but they’re finding that it’s not easy. Generation Ys grew up with computers and other modes of high technology, and they’re used to doing several things at once—simultaneously watching TV, texting, and playing games on the computer. As a result, they’re quite adept at tuning out ads. Try to reach them through TV ads and they’ll channel-surf right past them or hit their TiVo remotes.³⁰⁹ You can’t get to them over the Internet because they know all about pop-up blockers. In one desperate attempt to get their attention, an advertiser paid college students fifty cents to view thirty-second ads on their computers.³¹⁰ Advertisers keep trying, because Generation Y is big enough to wreck a brand by giving it a cold shoulder.

Consumer Behavior

Why did you buy an Apple computer when your friend bought a Dell PC? What information did you collect before making the decision? What factors did you consider when evaluating alternatives? How did you make your final choice? Were you happy with your decision? To design effective strategies, marketers need to find the answers that consumers give to questions such as these. In other words, they try to improve their understanding of consumer behavior—the decision process that individuals go through when purchasing or using products. In Section 9.8.7 "The Buying Process", we’ll look at the process that buyers go through in choosing one product over another. Then, we’ll explore some factors that influence consumers’ behavior.

The Buying Process

Generally speaking, buyers run through a series of steps in deciding whether to purchase a particular product. Some purchases are made without much thought. You probably don't think much, for example, about the brand of gasoline you put in your car; you just stop at the most convenient place. Other purchases, however, require considerable thought. For example, you probably spent a lot of time deciding which college to attend. Let's revisit that

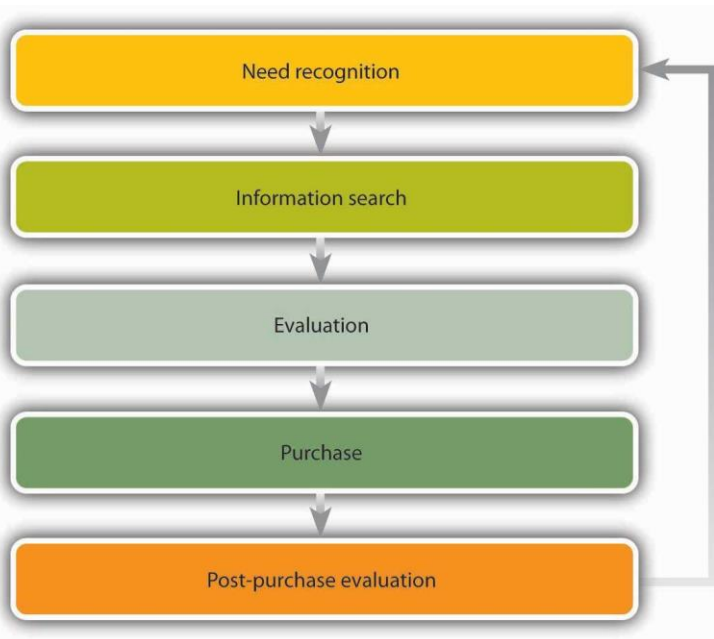


Figure 58 The Buying Process

decision as a means of examining the five steps that are involved in the consumer buying process and that are summarized in Figure 10 "The Buying Process": *need recognition, information search, evaluation, purchase, and post purchase evaluation.*

1. *Need recognition.* The process began when you recognized a need to go to college. Perhaps you wanted to prepare for a particular career, to become better educated, or to postpone going to work full time. Maybe your parents insisted.
2. *Information search.* Once you recognized the need to go to college, you probably started gathering information about colleges. You may have gone online and studied the Web sites posted by a few schools. Perhaps you attended college fairs or spoke with your high school guidance counselor. You probably talked with friends about your options. Once you let colleges know that you were interested, admissions departments likely sent you tons of information.
3. *Evaluation.* At this point, you studied the information you'd gathered. First, you probably decided what you wanted from a college. Perhaps price was your number-one criterion, or maybe distance from home. Maybe size was important, or reputation or available majors. Maybe it was the quality of the football team or the

male-to-female ratio.

4. *Purchase*. Ultimately you made a “purchase” decision. In so doing, you focused on what was most important to you. Naturally, you could choose only among schools that had accepted you.
5. *Post purchase evaluation*. The buying process didn’t end when you selected a school. It continues today, while you’re using the “product” you purchased. How many times have you rethought your decision? Are you happy with it? Would you make the same choice again?

Understanding the buying process of potential students is crucial to college administrators in developing marketing strategies to attract qualified “buyers.” They’d certainly like to know what information you found useful, which factors most influenced your decision, and how you made your final choice. They’ll also want to know whether you’re happy with your choice. This is the kind of information that colleges are seeking when they solicit feedback, both from students who chose their schools and from those who didn’t.

Influences on Buying Behavior

Did you ever buy something you knew you shouldn’t buy but just couldn’t help yourself—something you simply wanted? Maybe it was a spring-break trip to the Bahamas that you really couldn’t afford. Objectively, you may have made a bad decision, but not all decisions are made on a purely objective basis. *Psychological* and *social influences* come into play. Let’s take a closer look at each of these factors.

Psychological Influences

Under this category, we can identify at least five variables:

1. *Motivation*. The internal process that causes you to seek certain goals.
2. *Perception*. The way you select, organize, and interpret information.
3. *Learning*. Knowledge gained through experience and study.
4. *Attitudes*. Your predisposition to respond in particular ways because of learned values and beliefs.
5. *Personality*. The collection of attributes that characterize an individual.

Social Influences

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Here, we find four factors:

1. Family.
2. Reference groups. Friends or other people with whom you identify.
3. Economic or social status.
4. Culture. Your set of accepted values.

It shouldn't be surprising that marketers are keenly interested in the effect of all these influences on your buying decisions. For instance, suppose the travel agency that sold you your spring-break getaway found that you bought the package because you viewed it as a reward for studying hard and doing well academically. In that case, it might promote student summer-travel programs as rewards for a hard year's work at school.

Key Takeaways

- A number of forces over which it has little or no control affect a company's marketing activities.
- Taken together, they make up its **external marketing environment**, which includes regulatory and political activity, economic conditions, competitive forces, changes in technology, and social and cultural influences.
- Successful marketing often hinges on understanding **consumer behavior**—the decision process that individuals go through when purchasing or using products.
- Several psychological and social variables influence buyers' decisions. They go through a series of steps in reaching the decision to buy a product: *need recognition, information search, evaluation, purchase, and post purchase evaluation.*

Chapter 9 Review Questions

Multiple Choice:

- A _____ market is where a company directs its marketing efforts at its members.
 1. Target
 2. Consumer
 3. Industrial
- Population density is an example of _____ segmentation.
 1. Demographic
 2. Geographic
 3. Behavior
 4. Psychographic
- Receptiveness to usage is an example of _____ segmentation.
 1. Demographic
 2. Geographic
 3. Behavior
 4. Psychographic
- CVS Pharmacy is an example of _____ distribution.
 1. Intermediary
 2. Retailer
 3. Wholesaler
- SCM stands for _____.
 1. supply chain movement
 2. supply channel management
 3. supply chain management
 4. supplier controlled management

Short Answer:

1. What are the four most common ways to marketing segments?
2. What are the four Ps of the marketing mix?
3. What are the four strategies for pricing products?

Chapter 10 Product Design and Development

What Is a Product?

Learning Outcomes

1. Define product.
2. Describe the four major categories of product developments: new-to-the-market, new-to-the-company, improvement of existing product, and extension of product line.

Basically, a product is something that can be marketed to customers because it provides them with a benefit and satisfies a need. It can be a physical *good*, such as the PowerSki Jetboard, or a *service*, such as a haircut or a taxi ride. The distinction between goods and services isn't always clear-cut. Say, for example, that a company hires a professional to provide an in-house executive training program on "netiquette" (e-mail etiquette). Off the top of our heads, most of us would say that the company is buying a service. What if the program is offered online? We'd probably still argue that the product is a service. But what if the company buys training materials that the trainer furnishes on DVD? Is the customer still buying a service? Probably not: we'd have to say that when it buys the DVD, the company is buying a tangible good.

In this case, the product that satisfies the customer's need has both a tangible component (the training materials on DVD) and an intangible component (the educational activities performed by the seller). Not surprisingly, many products have both tangible and intangible components. If, for example, you buy a Hewlett-Packard computer, you get not only the computer (a tangible good) but certain promises to answer any technical questions that you might have and certain guarantees to fix your computer if it breaks within a specified time period (intangible services).

Types of Product Developments

New product developments can be grouped into four major categories: new-to-the-

company, improvement of existing product, extension of product line, and new-to-the-market.

For examples of the first three types of new product developments, we'll take a look at Just Born. The company is known for its famous "Marshmallow Peeps," and consequently its management is very interested in marshmallows. It conducted research that revealed that families use marshmallows in lots of ways, including crafts and decorating. This led Just Born to develop an Easter decorating kit that used Peeps marshmallows. It was such a hit that the company followed by creating decorating kits for Halloween and the Christmas season. Because similar products are made by other companies, the decorating kits are not "new to the market" but are "new to the company." Now, let's look at another product development involving Just Born's also famous Mike & Ike's. The marketing people at Just Born discovered that teenagers prefer to buy candies that come in pouches (which fit into their pants pockets) rather than in small boxes. In response, the company reduced the piece size, added some new ingredients, and put the Mike & Ike's in pouches. This "improvement in an existing product" resulted in a 20 percent annual sales jump for Mike & Ike's. Our last look at Just Born demonstrates an approach used by the company to "extend its existing product line." Most of us like chocolate and most of us also like marshmallow, so how about putting them together? This is just what Just Born did—the company extended its Peeps product line to include "Peeps in a chocolate egg." Consumers loved the combination, and its success prompted the company to extend its product line again and launch a chocolate crispy version for Easter.

New-to-the-Market Products

The PowerSki Jetboard is a "new-to-the-market product." Before it was invented, no comparable product existed. Launching a new-to-the-market product is very risky, and only about 10 percent of products created fall into this category. On a positive note, introducing a new product to the market can be very profitable, because the product often enjoys a temporary monopolistic position.

Entrepreneurial Start-Ups

Inventors of new-to-the-market products often form entrepreneurial start-ups to refine their product idea and bring it to market. This was the path taken by Bob Montgomery, inventor

of the PowerSki Jetboard. As is typical of entrepreneurial start-ups, the company that Montgomery founded has these characteristics:³¹¹

1. *It's characterized by innovative products and/or practices.* Before the PowerSki Jetboard was invented, no comparable product existed.
2. *Its goals include profitability and growth.* Because the patented Jetboard enjoys a temporary monopolistic position, PowerSki potentially could be very profitable.
3. *It focuses on new opportunities.* Bob Montgomery dreamed of creating the first motorized surfboard. This dream began when he and a few of his surfer friends (all around age twelve) missed a wave because it was too far down the beach for them to catch. He imagined that if he was on a motorized surfboard (instead of an ordinary one that you had to paddle), he would have been able to catch that wave. His dream became the mission of his company: "PowerSki International Corp. was founded to deliver the patented PowerSki Jetboard, the world's only motorized surfboard, and its engine technology to the world market. It's PowerSki's goal to bring the experience of surfing to everyone on lakes, rivers, seas, and the ocean. 'Now everybody has an ocean, and can ride an endless wave.'"³¹²
4. *Its owners are willing to take risks.* Anybody who starts any business is taking a risk of some kind. The key to *entrepreneurial* risk is related to the idea of innovation: as Woody Allen once put it, "If you're not failing every now and again, it's a sign you're not doing anything very innovative."³¹³

How to Take a Calculated Risk

As Montgomery learned, the introduction of an *innovative* product to the market is more unpredictable, and thus more risky, than the introduction of a market-tested product.

Starting up a store to sell an improved version of an existing surfboard entails one level of risk; starting up a business to market the first motorized surfboard entails quite another.

Even though the introduction of new-to-the-market products are more risky, some of this risk can be avoided. What if, for example, Montgomery had brought the Jetboard to market only to discover that many of the buyers in his target market—water- sports enthusiasts—couldn't easily maneuver the Jetboard? We could then say that he took an unnecessarily

risky step in bringing his product to market, but we could also say that he simply attempted to market his product without adequate information. Surely a little research would have alerted Montgomery to the probable consequences of his decision to go to market when he did and with his product in its current state of development.

A couple of final words, therefore, about introducing an entirely new product to the market. First, this type of product introduction is about carefully *calculated* risks, not *unnecessary* risks. Second, though little is certain in the entrepreneurial world, most decision making can be improved with input from one or both of two sources:

1. Information gathered from research
2. Knowledge gained from personal experience

Again, you can't be *certain* about any results, but remember that *uncertainty* reflects merely the lack of complete knowledge or information; thus, the more knowledge and information that you can bring to bear on a situation, the less uncertain—and the less risky—the decision becomes.³¹⁴ In short, always do your homework, and if you're new to entrepreneurship or to your market, make it a point to work with people who know from experience what they're talking about.

Key Takeaways

- A **product** is something that can be marketed to customers because it provides them with a benefit and satisfies a need. Products can be goods or services or a combination of both.
- A “new-to-the-company product” is a good or a service that is new to the company but has been sold by a competitor in the past—for example, Peeps marshmallow Easter decorating kits.
- An “improvement in an existing product” is an enhancement of a product already on the market—for example, a change of ingredients and packaging for Mike & Ike's.
- An “extension to an existing product line” is a new product developed as a variation of an already existing product—for example, Peeps chocolate eggs.

- A “new-to-the-market product” is a good or a service that has not been available to consumers or manufacturers in the past—for example, the PowerSki Jetboard.
- Four characteristics of the entrepreneurial start-up are:
 1. *It’s characterized by innovative products and/or practices.*
 2. *Its goals include profitability and growth.*
 3. *It focuses on new opportunities.*
 4. *Its owners are willing to take risks.*
- Entrepreneurship is about carefully *calculated* risks, not *unnecessary* risks. Most entrepreneurial decision making can be improved with input from one or both of two sources:
 1. *Information gathered from research*
 2. *Knowledge gained from personal experience*

Identifying Business Opportunities

Learning Outcomes

1. Explain how an idea turns into a business opportunity.
2. Describe the four types of utility provided by a product: time, place, ownership, and form.

An idea turns into a business opportunity when it has commercial potential—when you can make money by selling the product. But needless to say, not all ideas generate business opportunities. Consider these products that made the list of the “Top 25 Biggest Product Flops of All Time”:³¹⁵

- *Bic underwear.* When you think of Bic you think of inexpensive pens and disposable razors and lighters. But disposable underwear? Women didn’t find the idea of buying intimate attire from a pen manufacturer appealing, and the disposability factor was just plain weird.
- *Harley Davidson perfume.* Even its loyal fans found the idea of Harley-Davidson perfume peculiar (and they weren’t terribly fond of the Harley-Davidson aftershave,

either). Perhaps they were afraid they would end up smelling like a motorcycle.

- *Bottled water for pets.* OK, so people love their pets and cater to them, but does it really make sense to serve Thirsty Cat! and Thirsty Dog! bottled water to your four-legged friends? Even though the water came in tantalizing flavors such as Crispy Beef and Tangy Fish, it never caught on. Do you wonder why?
- *Colgate kitchen entrees.* Colgate's entrance into food products wasn't well received. Maybe the company believed customers would buy into the idea of eating one of its prepared meals and then brushing their teeth with Colgate toothpaste. For most of us, the name Colgate doesn't get our taste buds tingling.

Utility

Remember: being in business is not about you—it's about the customer. Successful businesspeople don't ask themselves "What do I want to sell?" but rather "What does the customer want to buy?" *Customers buy products to fill unmet needs and because they expect to derive some value or utility from them.* People don't buy Alka-Seltzer because they like the taste or even because the price is right: they buy it because it makes their indigestion go away. They don't shop at Amazon.com because the Web site is entertaining: they shop there because they want their purchases delivered quickly. The realization that this kind of service would meet customer needs made Amazon.com a genuine business opportunity.

Products provide customers with four types of utility or benefit:

- *Time utility.* The value to a consumer of having a good or a service available at a convenient time. A concessionaire selling bottled water at a summer concert is making liquid refreshment available when it's needed.
- *Place utility.* The value to a consumer of having a product available in a convenient location. A street vendor selling hotdogs outside an office building is making fast food available where it's needed.
- *Ownership utility.* Value created by transferring a product's ownership. A real estate agent helping a young couple buy a home is transferring ownership from someone who doesn't need it to someone who does.
- *Form utility.* The value to consumers from changing the composition of a product. A

company that makes apparel is turning raw material (fabric) into a form (clothing) that people need. A company that produces liquid detergent, rather than powdered detergent, is adding form utility for some consumers.

How can you decide whether an idea provides utility and has the potential to become a business opportunity? You should start by asking yourself the questions in Figure 1 "When Is an Idea a Business Opportunity?": if

Ask yourself:



Figure 59 When Is an Idea a Business Opportunity?

you can't come up with good answers to these questions, you probably don't have a highly promising product. On the other hand, if you conclude that you have a potential product for which people would pay money, you're ready to take the next step: analyze the market to see whether you should go forward with the development of the product.

Key Takeaways

- An idea turns into a business opportunity when it has commercial potential—when you can make money by selling the product.
- Time utility provides value by having a product available at a convenient time.
- Place utility provides value by having a product available in a convenient location.
- Ownership utility provides value by transferring a product's ownership.
- Form utility provides value by changing the composition of a product.

Understand Your Industry

Learning Outcome

1. Explain how to research an industry.

Before you invest a lot of time and money to develop a new product, you need to understand the industry in which it's going to be sold. As inventor of the PowerSki Jetboard, Bob Montgomery had the advantage of being quite familiar with the industry that he proposed to enter. With more than twenty years' experience in the water-sports and personal-watercraft industry, he felt at home in this business environment. He knew who his potential customers were, and he knew who his competitors were. He had experience in marketing similar products, and he was familiar with industry regulations. Most people don't have the same head start as Montgomery. So, how does the average would-be businessperson learn about an industry? What should you want to know about it? Let's tackle the first question first.

Evaluating Your Industry

Before you can study an industry, you need to know what industry to study. An industry is a group of related businesses: they do similar things and they compete with each other. In the footwear industry, for example, firms make footwear, sell it, or both. Players in the industry include Nike and Adidas, both of which specialize in athletic footwear; but the industry is also sprinkled with companies like Candies (which sells young women's fashion footwear) and Florsheim (quality men's dress shoes). Let's say that you want to know something about the footwear industry because your potential purple cow is a line of jogging shoes designed specifically for older people (those over sixty-five) who live in the Southeast. You'd certainly need a broad understanding of the footwear industry, but would general knowledge be enough? Wouldn't you feel more comfortable about pursuing your idea if you could focus on a smaller segment of the industry—namely, the segment that specializes in products similar to the one you plan to sell? Here's a method that will help you narrow your focus.³¹⁶

Segmenting Your Market

Begin with the overall industry—in this case, the footwear industry. Within this industry, there are several groups of customers, each of which is a market. You're interested in the

consumer market—retail customers. But this, too, is a fairly broad market; it includes everybody who buys shoes at retail. Your next step, then, is to subdivide this market into smaller market segments—groups of potential customers with common characteristics that influence their buying decisions. You can use a variety of standard characteristics, including *demographics* (age, sex, income), *geography* (region, climate, city size), and *psychographics* (lifestyle, activities, interests). The segment you're interested in consists of older people (a demographic variable) living in the Southeast (a geographic variable) who jog (a psychographic variable). Within this market segment, you might want to subdivide further and find a niche—an unmet need. Your niche might turn out to be providing high-quality jogging shoes to active adults living in retirement communities in Florida.

The goal of this process is to identify progressively narrower sectors of a given industry. You need to become familiar with the whole industry—not only with the footwear industry but also with the retail market for jogging shoes designed for older people. You also need to understand your niche market, which consists of older people who live active lives in Florida.

Now that we know something about the process of focusing in on an industry, let's look at another example. Suppose that your product idea is offering dedicated cruises for college students. You'd begin by looking at the recreational-activities *industry*. Your *market* would be people who travel for leisure, and within that market, you'd focus on the *market segment* consisting of people who take cruises. Your *niche* would be college students who want to take cruises.

Assessing Your Competition

Now that you've identified your industry and its various sectors, you're ready to consider such questions as the following:³¹⁷

- Is the industry growing or contracting? Are sales revenues increasing or decreasing?
- Who are your major competitors? How does your product differ from those of your competitors?
- What opportunities exist in the industry? What threats?
- Has the industry undergone recent changes? Where is it headed?

- How important is technology to the industry? Has it brought about changes?
- Is the industry mature, or are new companies successfully entering it?
- Do companies in the industry make reasonable profits?

Where do you find answers to questions such as these? A good place to start is by studying your competitors: Who are their customers? What products do they sell? How do they price their products? How do they market them? How do they treat their customers? Do they seem to be operating successfully? Observe their operations and buy their goods and services. Search for published information on your competitors and the industry. For example, there's a great deal of information about companies on the Internet, particularly in company Web sites. The Internet is also a good source of industry information. Look for the site posted by the industry trade association. Find out whether it publishes a magazine or other materials. Talk with people in the industry— business owners, managers, suppliers; these people are usually experts. And talk with customers. What do they like or dislike about the products that are currently available? What benefits are they looking for? What benefits are they getting?

Key Takeaways

- Before developing a new product, you need to understand the industry in which it will be sold.
- An **industry** is a group of related businesses that do similar things and compete with each other.
- To research an industry, you begin by studying the overall industry and then progressively narrow your search by looking at smaller sectors of the industry, including **markets** (or groups of customers) and **market segments** (smaller groups of customers with common characteristics that influence their buying decisions).
- Within a market segment, you might want to subdivide further to isolate a **niche**, or unmet need.

Forecasting Demand

Learning Outcome

1. Forecast demand for a product.

It goes without saying, but we'll say it anyway: without enough customers, your business will go nowhere. So, before you delve into the complex, expensive world of developing and marketing a new product, ask yourself questions like those in Figure 2 "When to Develop and Market a New Product".

When Bob Montgomery asked himself these questions, he concluded that he had two groups of customers for the PowerSki Jetboard: (1) the dealerships that would sell the product and (2) the water-sports enthusiasts who would buy and use it. His job, therefore, was to design a product that dealers would

want to sell and enthusiasts would buy. When he was confident that he could satisfy these criteria, he moved forward with his plans to develop the PowerSki Jetboard.

After you've identified a group of potential customers, your next step is finding out as much as you can about what they think of your product idea. Remember: because your ultimate goal is to roll out a product that satisfies customer needs, you need to know ahead of time what your potential customers want. Precisely what are their unmet needs? Ask them questions such as these:³¹⁸

- What do you like about this product idea? What don't you like?
- What improvements would you make?
- What benefits would you get from it?
- Would you buy it? Why, or why not?

Ask yourself:

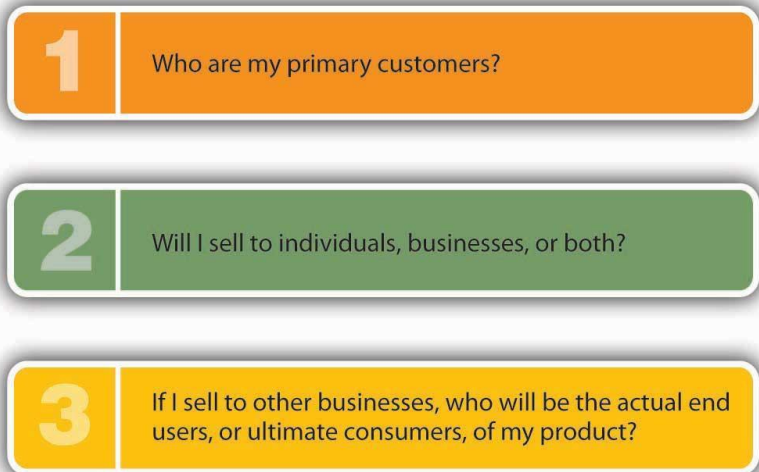


Figure 60 When to Develop and Market a New Product

- What would it take for you to buy it?

Before making a substantial investment in the development of a product, you need to ask yourself yet another question: are there enough customers willing to buy my product at a price that will allow me to make a profit? Answering this question means performing one of the hardest tasks in business: forecasting demand for your proposed product. There are several possible approaches to this task that can be used alone or in combination.

People in Similar Businesses

Though some businesspeople are reluctant to share proprietary information, such as sales volume, others are willing to help out individuals starting new businesses or launching new products. Talking to people in your prospective industry (or one that's similar) can be especially helpful if your proposed product is a service. Say, for example, that you plan to open a pizza parlor with a soap opera theme: customers will be able to eat pizza while watching reruns of their favorite soap operas on personal TV/DVD sets. If you visited a few local restaurants and asked owners how many customers they served every day, you'd probably learn enough to estimate the number of pizzas that you'd serve during your first year. If the owners weren't cooperative, you could just hang out and make an informal count of the customers.

Potential Customers

You can also learn a lot by talking with potential customers. Ask them how often they buy products similar to the one you want to launch. Where do they buy them and in what quantity? What factors affect demand for them? If you were contemplating a frozen yogurt store in Michigan, it wouldn't hurt to ask customers coming out of a bakery whether they'd buy frozen yogurt in the winter.

Published Industry Data

To get some idea of the total market for products like the one you want to launch, you might begin by examining pertinent industry research. For example, to estimate demand for jogging shoes among consumers sixty-five and older, you could look at data published on the industry association's Web site, National Sporting Goods Association, <https://www.nsga.org/research/research-center/>³¹⁹ Here you'd find that forty million jogging/running shoes were sold in the United States in 2008 at an average price of \$58

per pair. The Web site also reports that the number of athletes who are at least forty and who participate in road events increased by more than 50 percent over a ten year period.³²⁰ To find more specific information—say, the number of joggers older than sixty-five—you could call or e-mail USA Track and Field. You might find this information in an eighty-seven-page statistical study of retail sporting-goods sales published by the National Sporting Goods Association.³²¹ If you still don't get a useful answer, try contacting organizations that sell industry data. American Sports Data, for instance, provides demographic information on no fewer than twenty-eight fitness activities, including jogging.³²² You'd want to ask them for data on the number of joggers older than sixty-five living in Florida. There's a lot of valuable and available industry-related information that you can use to estimate demand for your product.

Now, let's say that your research turns up the fact that there are three million joggers older than sixty-five and that six hundred thousand of them live in Florida, which attracts 20 percent of all people who move when they retire.³²³ How do you use this information to estimate the number of jogging shoes that you'll be able to sell during your first year of business? First, you have to estimate your market share: your portion of total sales in the older-than-sixty-five jogging shoe market in Florida. Being realistic (but having faith in an excellent product), you estimate that you'll capture 2 percent of the market during your first year. So you do the math: 600,000 pairs of jogging shoes sold in Florida \times 0.02 (a 2 percent share of the market) = 12,000, the estimated first-year demand for your proposed product.

Granted, this is just an estimate. But at least it's an educated guess rather than a wild one. You'll still want to talk with people in the industry, as well as potential customers, to hear their views on the demand for your product. Only then would you use your sales estimate to make financial projections and decide whether your proposed business is financially feasible. We'll discuss this process in a later chapter.

Key Takeaways

- After you've identified a group of potential customers, your next step is finding out as much as you can about what they think of your product idea.
- Before making a substantial investment in the development of a product, you need to ask yourself: are there enough customers willing to buy my product at a price that will allow me to make a profit?
- Answering this question means performing one of the hardest tasks in business: forecasting demand for your proposed product.
- There are several possible approaches to this task that can be used alone or in combination.
- You can obtain helpful information about product demand by talking with people in similar businesses and potential customers.
- You can also examine published industry data to estimate the total market for products like yours and estimate your **market share**, or portion of the targeted market.

Breakeven Analysis

Learning Outcome

1. Learn how to use breakeven analysis to estimate the number of sales units at which net income is zero.

Forecasting sales of shoes has started you thinking. Selling twelve thousand pair of shoes the first year you run the business sounds great, but you still need to find an answer to the all-important question: are there enough customers willing to buy my jogging shoes at a price that will allow me to make a profit? Is there some way to figure out the level of sales I would need to avoid *losing* money—to “break even”? Fortunately, an accountant friend of yours informs you that there is. Not surprisingly, it's called breakeven analysis, and here's how it works: to break even (have no profit or loss), *total sales revenue must exactly equal all your expenses (both variable and fixed)*. To determine the level of sales at which this will occur, you need to do the following:

1. Determine your total fixed costs, which are so called because the total cost doesn't change as the quantity of goods sold changes:
 - Fixed costs = \$210,000 salaries + \$60,000 rent + \$10,000 advertising + \$8,000 insurance + 12,000 other fixed costs = \$300,000

2. Identify your variable costs. These are costs that vary, in total, as the quantity of goods sold changes but that stay constant on a per-unit basis. State variable costs on a per-unit basis:
 - Variable cost per unit = \$40 (cost of each pair of shoes) + \$5 sales commission = \$45

3. Determine your contribution margin per unit: selling price per unit less variable cost per unit:
 - Contribution margin per unit = \$80 selling price minus \$45 variable cost per unit = \$35

4. Calculate your breakeven point in units: fixed costs ÷ contribution margin per unit:
 - Breakeven in units = \$300,000 fixed costs ÷ \$35 contribution margin per unit = 8,571 units

Your calculation means that if you sell 8,571 pairs of shoes, you will end up with zero profit (or loss) and will exactly break even.

If your sales estimate is realistic (a big "if"), then you should be optimistic about starting the business. All your fixed costs will be covered once you sell 8,571 pairs of shoes. Any sales above that level will be pure profit. So, if you sell your expected level of twelve thousand pairs of shoes, you'll make a profit of \$120,015 for the first year. Here's how we calculated that profit:

- 12,000 expected sales level – 8,571 breakeven sales level = 3,429 units × \$35 contribution margin per unit = \$120,015 first-year profit

As you can see, breakeven analysis is pretty handy. It allows you to determine the level of

sales that you must reach to avoid losing money and the profit you'll make if you reach a higher sales goal. Such information will help you plan for your business.

Key Takeaways

- Breakeven analysis is a method of determining the level of sales at which the company will break even (have no profit or loss).
- The following information is used in calculating the breakeven point: fixed costs, variable costs, and contribution margin per unit.
- Fixed costs are costs that don't change when the amount of goods sold changes. For example, rent is a fixed cost.
- Variable costs are costs that vary, in total, as the quantity of goods sold changes but stay constant on a per-unit basis. For example, sales commissions paid based on unit sales are a variable cost.
- Contribution margin per unit is the excess revenue per unit over the variable cost per unit.
- The breakeven point in units is calculated with this formula: fixed costs divided by contribution margin per unit (selling price per unit less variable cost per unit).

Product Development

Learning Outcome

1. Describe the process of developing a product that meets customer needs.

Like PowerSki, every organization—whether it produces goods or provides services—sees Job 1 as furnishing customers with quality products. The success of a business depends on its ability to identify the unmet needs of consumers and to develop products that meet those needs at a low cost.³²⁴ In other words, effective product development results in goods and services that can be sold at a profit. In addition, it results in high-quality products that not only satisfy consumer needs but also can be developed in a timely, cost-efficient manner. Accomplishing these goals entails a collaborative effort by individuals from all areas of an organization: operations management (including representatives from

engineering, design, and manufacturing), marketing, accounting, and finance. In fact, companies increasingly assign representatives from various functional areas who work together as a project team throughout the product development processes. This approach allows individuals with varied backgrounds and experience to provide input as the product is being developed.

Product Development Is a Risky Proposition

Not surprisingly, developing profitable products is difficult, and the success rate is low. On average, for every successful product, a company has twelve failures. At this rate, the firms on the *Fortune* 1000 list waste over \$60 billion a year in research and development.³²⁵ There are several reasons why product development is such a risky proposition:

- *Trade-offs.* You might, for instance, be able to make your jogging shoes lighter than your competitors', but if you do, they probably won't wear as well. They could be of higher quality, but that will make them more costly (they might price themselves out of the market).
- *Time pressure.* Developing a product can require hundreds of decisions that must be made quickly and with imperfect information.
- *Economics.* Because developing a product requires a lot of time and money, there's always pressure to make sure that the project not only results in a successful product but also gets it to market at the most opportune time. Failure to be first to market with an otherwise desirable new product can cost a company a great deal of money.

Even so, organizations continue to dedicate immense resources to developing new products. Your supermarket, for example, can choose from about one hundred thousand items to carry on its shelves—including twenty thousand *new* products every year. Unfortunately, the typical supermarket can stock only thirty thousand products.³²⁶

The Product Development Process

The product development process is a series of activities by which a product idea is transformed into a final product. It can be broken down into the seven steps summarized in Figure 3 "The Product Development Process".

Evaluate Opportunities and Select the Best Product Idea

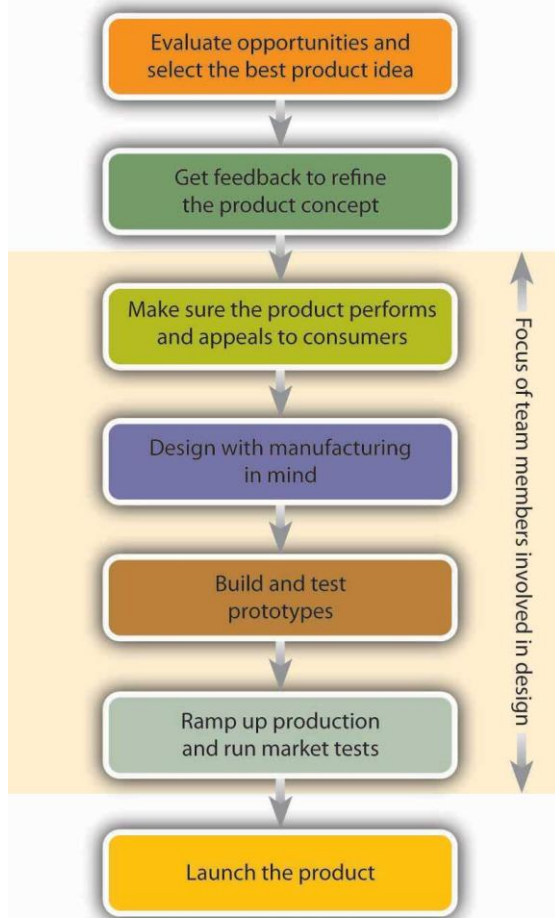


Figure 61 The Product Development Process

If you're starting your first business, you might have only one product idea. But existing organizations often have several ideas for new products, as well as improvements to existing ones. Where do they come from? They can come from individuals within the organization or from outside sources, such as customers. Typically, various ideas are reviewed and evaluated by a team of individuals, who identify the most promising ideas for development. They may rely on a variety of criteria: Does the proposed product fill an unmet need of our customers? Will enough people buy our product to make it commercially successful? Do we have the resources and expertise to make it?

Get Feedback to Refine the Product Concept

From the selected product idea, the team generates an initial product concept that describes what the product might look like and how it might work. Members talk both with other people in the organization and with potential buyers to identify customer needs and the benefits that consumers will get from the product. They study the industry in which the product will be sold and investigate competing products. They brainstorm various *product designs*—that is, the specifications for how the product is to be made, what it's to look like, and what performance standards it's to meet. Based on information gathered through this process, the team will revise the product concept, probably pinpointing several alternative models. Then they'll go back to potential customers and get their feedback on both the basic concept and the various alternatives. Based on this feedback, the team will decide what the product will look like, how it will work, and what features it will have.

Make Sure the Product Performs and Appeals to Consumers

The team then decides how the product will be made, what components it will require, and how it will be assembled. It will decide whether the product should be made in-house or outsourced to other companies. For products to be made in-house, the team determines where parts will be obtained. During this phase, team members are involved in design work to ensure that the product will be appealing, safe, and easy to use and maintain.

Design with Manufacturing in Mind

As a rule, there's more than one way to make any product, and some methods are more expensive than others. During the next phase, therefore, the team focuses its attention on making a high-quality product at the lowest possible cost, working to minimize the number of parts and simplify the components. The goal is to build both quality and efficiency into the manufacturing process.

Build and Test Prototypes

A prototype is a physical model of the product. In the next phase, prototypes are produced and tested to make sure that the product meets the customer needs that it's supposed to. The team usually begins with a preliminary prototype from which, based on feedback from potential customers, a more sophisticated model will then be developed. The process of building and testing prototypes will continue until the team feels comfortable that it has fashioned the best possible product. The final prototype will be extensively tested by customers to identify any changes that need to be made before the finished product is introduced.

Ramp Up Production and Run Market Tests

During the production ramp-up stage, employees are trained in manufacturing and assembly processes. Products turned out during this phase are carefully inspected for residual flaws. Samples are often demonstrated or given to potential customers for testing and feedback.

Launch the Product

In the final stage, the firm starts ongoing production and makes the product available for widespread distribution.

Key Takeaways

- The success of a business depends on its ability to identify the unmet needs of consumers and to develop products that meet those needs at a reasonable cost.
- Accomplishing these goals requires a collaborative effort by individuals from all areas of the organization: operations management (including representatives from engineering, design, and manufacturing), marketing, accounting, and finance.
- Representatives from these various functional areas often work together as **project teams** throughout the **product development process**, which consists of a series of activities that transform a product idea into a final product.
- This process can be broken down into seven steps:
 1. Evaluate opportunities and select the best product mix
 2. Get feedback to refine the **product concept** that describes what the product might look like and how it might work
 3. Make sure that the product performs and appeals to consumers
 4. Design with manufacturing in mind to build both quality and efficiency into the manufacturing process
 5. Build and test **prototypes**, or physical models of the product
 6. Run market tests and enter the **ramp-up stage** during which employees are trained in the production process
 7. Launch the product

Chapter 10 Review Questions

Multiple Choice:

- When there is value to a consumer of having a product available in a convenient location, there is ____ utility.
 1. Time
 2. Place
 3. Ownership
 4. Form
- When a company that produces liquid detergent, rather than powdered detergent, there is ____ utility.
 1. Time
 2. Place
 3. Ownership
 4. Form
- Before developing a new product, you need to understand the _____ in which it will be sold.
 1. Segment
 2. Industry
 3. Method
 4. Time
- The first steps in developing a breakeven analysis is to determine your _____.
 1. Sales
 2. Margin
 3. Profit
 4. Costs
- Within the product development process, this step involves talking both with other people in the organization and with potential buyers.
 1. Evaluate Opportunities and Select the Best Product Idea
 2. Get Feedback to Refine the Product Concept
 3. Make Sure the Product Performs and Appeals to Consumers
 4. Design with Manufacturing in Mind

Short Answer:

1. What three questions should we ask when thinking about a business opportunity?
2. What are the four forms of utility or benefit?
3. Describe what a breakeven analysis is.

Chapter 11 Operations Management in Manufacturing and Service Industries

Operations Management in Manufacturing

Learning Outcomes

1. Define operations management, and discuss the role of the operations manager in a manufacturing company.
2. Describe the decisions made in planning the production process in a manufacturing company.

Like PowerSki, every organization—whether it produces goods or provides services—sees Job 1 as furnishing customers with quality products. Thus, to compete with other organizations, a company must convert resources (materials, labor, money, information) into goods or services as efficiently as possible. The upper-level manager who directs this transformation process is called an *operations manager*. The job of operations management (OM), then, consists of all the activities involved in transforming a product idea into a finished product, as well as those involved in planning and controlling the systems that produce goods and services. In other words, operations managers manage the process that transforms inputs into outputs. Figure 1 "The Transformation Process" illustrates this traditional function of operations management.

In the rest of this chapter, we'll discuss the major activities of operations managers. We'll start by describing the role that operations managers play in the various processes designed to produce goods and offer services. Next, we'll look at the production of goods in manufacturing firms; then, we'll describe operations management activities in companies that provide services. We'll wrap up the chapter by explaining the role of operations management in such processes as quality control and outsourcing.

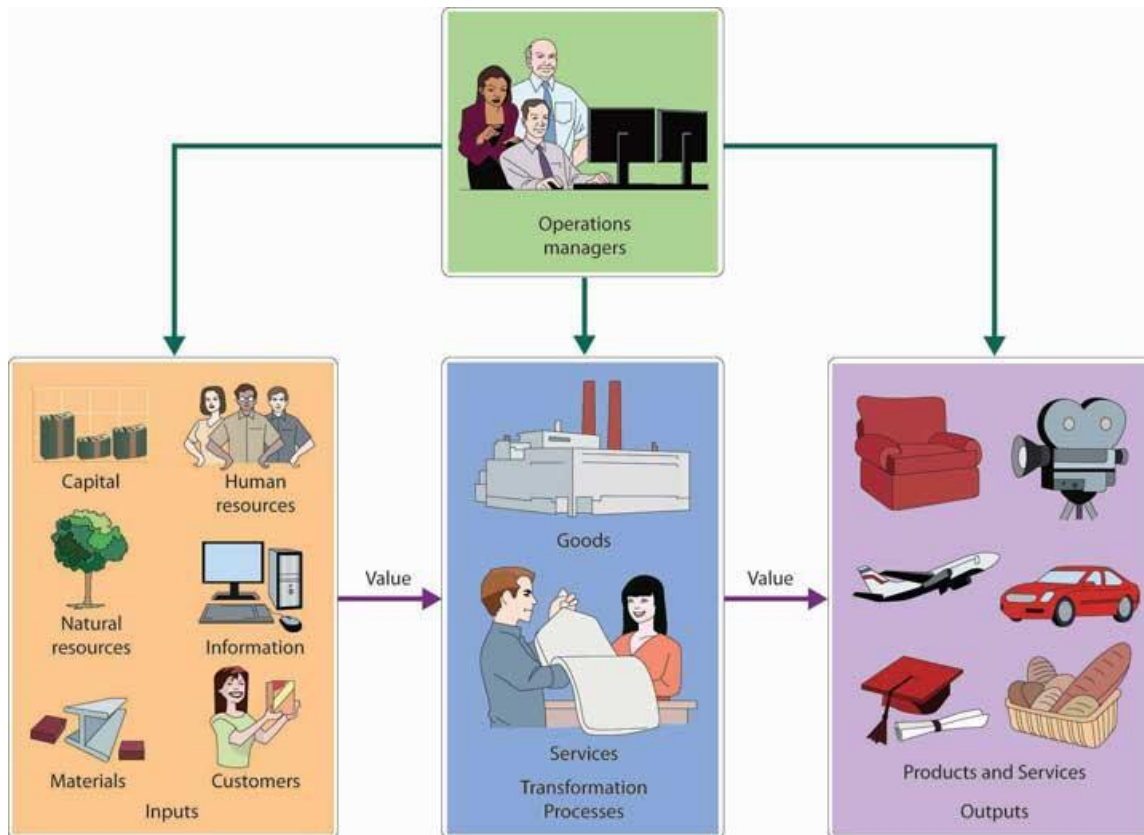


Figure 62 The Transformation Process

Operations Management in Manufacturing

Like PowerSki, all manufacturers set out to perform the same basic function: *to transform resources into finished goods*. To perform this function in today's business environment, manufacturers must continually strive to improve operational efficiency. They must fine-tune their production processes to focus on quality, to hold down the costs of materials and labor, and to eliminate all costs that add no value to the finished product. Making the decisions involved in the effort to attain these goals is the job of the operations manager. That person's responsibilities can be grouped as follows:

1. *Production planning*. During production planning, managers determine how goods will be produced, where production will take place, and how manufacturing facilities will be laid out.
2. *Production control*. Once the production process is under way, managers must continually schedule and monitor the activities that make up that process. They must solicit and respond to feedback and make adjustments where needed. At this stage,

they also oversee the purchasing of raw materials and the handling of inventories.

3. *Quality control.* Finally, the operations manager is directly involved in efforts to ensure that goods are produced according to specifications and that quality standards are maintained.

Let's take a closer look at each of these responsibilities.

Planning the Production Process

The decisions made in the planning stage have long-range implications and are crucial to a firm's success. Before making decisions about the operations process, managers must consider the goals set by marketing managers. Does the company intend to be a low-cost producer and to compete on the basis of price? Or does it plan to focus on quality and go after the high end of the market? Perhaps it wants to build a reputation for reliability. What if it intends to offer a wide range of products? To make things even more complicated, all these decisions involve trade-offs. Upholding a reputation for reliability isn't necessarily compatible with offering a wide range of products. Low cost doesn't normally go hand in hand with high quality.

With these factors in mind, let's look at the specific types of decisions that have to be made in the production planning process. We've divided these decisions into those dealing with production methods, site selection, facility layout, and components and materials management.

Production-Method Decisions

The first step in production planning is deciding which type of production process is best for making the goods that your company intends to manufacture. In reaching this decision, you should answer such questions as the following:

- How much input do I receive from a particular customer before producing my goods?
- Am I making a one-of-a-kind good based solely on customer specifications, or am I producing high-volume standardized goods to be sold later?
- Do I offer customers the option of "customizing" an otherwise standardized good to meet their specific needs?

One way to appreciate the nature of this decision is by comparing three basic types of processes or methods: *make-to-order*, *mass production*, and *mass customization*. The task of the operations manager is to work with other managers, particularly marketers, to select the process that best serves the needs of the company's customers.

Make-to-Order

At one time, most consumer goods, such as furniture and clothing, were made by individuals practicing various crafts. By their very nature, products were *customized* to meet the needs of the buyers who ordered them. This process, which is called a make-to-order strategy, is still commonly used by such businesses as print or sign shops that produce low-volume, high-variety goods according to customer specifications.

Mass Production

By the early twentieth century, however, a new concept of producing goods had been introduced: mass production (or make-to-stock strategy) is the practice of producing high volumes of identical goods at a cost low enough to price them for large numbers of customers. Goods are made in anticipation of future demand (based on forecasts) and kept in inventory for later sale. This approach is particularly appropriate for standardized goods ranging from processed foods to electronic appliances.

Mass Customization

But there's a disadvantage to mass production: customers, as one contemporary advertising slogan puts it, can't "have it their way." They have to accept standardized products as they come off assembly lines. Increasingly, however, customers are looking for products that are designed to accommodate individual tastes or needs but can still be bought at reasonable prices. To meet the demands of these consumers, many companies have turned to an approach called mass customization, which (as the term suggests) combines the advantages of customized products with those of mass production.

This approach requires that a company interact with the customer to find out exactly what the customer wants and then manufacture the good, using efficient production methods to hold down costs. One efficient method is to mass-produce a product up to a certain cut-off point and then to customize it to satisfy different customers.

The list of companies devoting at least a portion of their operations to mass customization is growing steadily. One of the best-known mass customizer is Nike, which has achieved success by allowing customers to configure their own athletic shoes, apparel, and equipment through Nike's iD program. The Web has a lot to do with the growth of mass customization. Levi's, for instance, lets a woman find a pair of perfect fitting jeans by going through an online fitting process that first identifies her "curve" type: *slight* (straight figure), *demi* (evenly proportioned), *bold* (curvy figure, which experiences waist gapping in the back), and *supreme* (curviest shape, which needs a higher rise in the back). Oakley offers customized sunglasses, goggles, watches, and backpacks, while Mars, Inc. can make M&M's in any color the customer wants (say, school colors) as well as add text and pictures to the candy.³²⁷

Naturally, mass customization doesn't work for all types of goods. Most people don't care about customized detergents or paper products (although a customized Kleenex tissue box with your picture on it and a statement that says, "go ahead...cry over me!" might come in handy after a relationship breakup with your significant other.)³²⁸ And while many of us like the idea of customized clothes, footwear, or sunglasses from Levi's, Nike, or Oakley, we often aren't willing to pay the higher prices they command.

Facilities Decisions

After selecting the best production process, operations managers must then decide where the goods will be manufactured, how large the manufacturing facilities will be, and how those facilities will be laid out.

Site Selection

In choosing a location, managers must consider several factors:

- To minimize shipping costs, both for raw materials coming into the plant and for finished goods going out, managers often want to locate plants close to suppliers, customers, or both.
- They generally want to locate in areas with ample numbers of skilled workers.
- They naturally prefer locations where they and their families will enjoy living.
- They want locations where costs for resources and other expenses—land, labor, construction, utilities, and taxes—are low.

- They look for locations with a favorable business climate—one in which, for example, local governments might offer financial incentives (such as tax breaks) to entice them to do business in their locales.

Managers rarely find locations that meet all these criteria. As a rule, they identify the most important criteria and aim at satisfying them. In deciding to locate in San Clemente, California, for instance, PowerSki was able to satisfy three important criteria:

1. Proximity to the firm's suppliers
2. Availability of skilled engineers and technicians
3. Favorable living conditions. These factors were more important than operating in a low-cost region or getting financial incentives from local government. Because PowerSki distributes its products throughout the world, proximity to customers was also unimportant.

Capacity Planning

Now that you know *where* you're going to locate, you have to decide on the quantity of products that you'll produce. You begin by *forecasting* demand for your product. As we discussed in Chapter 10 "Product Design and Development", forecasting isn't easy. To estimate the number of units that you're likely to sell over a given period, you have to understand the industry that you're in and estimate your likely share of the market by reviewing industry data and conducting other forms of research.

Once you've forecasted the demand for your product, you can calculate the capacity requirements of your production facility—the maximum number of goods that it can produce over a given time under normal working conditions. In turn, having calculated your capacity requirements, you're ready to determine how much investment in plant and equipment you'll have to make, as well as the number of labor hours required for the plant to produce at capacity.

Like forecasting, capacity planning is difficult. Unfortunately, failing to balance capacity and projected demand can be seriously detrimental to your bottom line. If you set capacity too low (and so produce less than you should), you won't be able to meet demand, and you'll lose sales and customers. If you set capacity too high (and turn out more units than

you should), you'll waste resources and inflate operating costs.

Key Takeaways

- The job of **operations management** is to oversee the process of transforming resources into goods and services.
- The role of operations managers in the manufacturing sector includes production planning, production control, and quality control.
- During production planning, managers determine how goods will be produced (production process), where production will take place (site selection), and how manufacturing facilities will be laid out (layout planning).
- In selecting the appropriate production process, managers compare three basic methods: **make-to-order strategy** (goods are made to customer specifications), **mass production** or **make-to-stock strategy** (high volumes of goods are made and held in inventory for later sale), and **mass customization** (high volumes of customized goods are made).
- In choosing the site for a company's manufacturing operations, managers look for locations that minimize shipping costs, have an ample supply of skilled workers, provide a favorable community for workers and their families, offer resources at low cost, and have a favorable business climate.
- Managers estimate the quantity of products to be produced by forecasting demand for their product and then calculating the capacity requirements of the production facility—the maximum number of goods that it can produce over a given period under normal working conditions.

Facility Layouts

Learning Outcome

1. Describe four major types of facility layouts: process, product, cellular, and fixed position.

The next step in production planning is deciding on plant layout—how equipment, machinery, and people will be arranged to make the production process as efficient as

possible. In this section, we'll examine four common types of facility layouts: process, product, cellular, and fixed position.

The process layout groups together workers or departments that perform similar tasks.

Goods in process (goods not yet finished) move from one workstation to another. At each position, workers use specialized equipment to perform a particular step in the production process.

To better understand how this layout works, we'll look at the production process at the Vermont Teddy Bear Company. Let's say that you just placed an order for a personalized teddy bear—a "hiker bear" with khaki shorts, a white T-shirt with your name embroidered on it, faux-leather hiking boots, and a nylon backpack with sleeping bag.

Your bear begins at the fur-cutting workstation, where its honey-brown "fur" coat is cut. It then moves to the stuffing and sewing workstation to get its insides and have its sides stitched together.

Next, it moves to the dressing station, where it's outfitted with all the cool clothes and gear that you ordered. Finally, it winds up in the shipping station and starts its journey to your house.

For a more colorful "Online Mini-Tour" of this process, log on to the Vermont Teddy Bear Web site at <http://www.vermontteddybear.com/Static/Tour-Welcomestation.aspx> (or see Figure 2 "Process Layout at Vermont Teddy Bear Company").

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(or see Figure 2 "Process Layout at Vermont Teddy Bear Company").

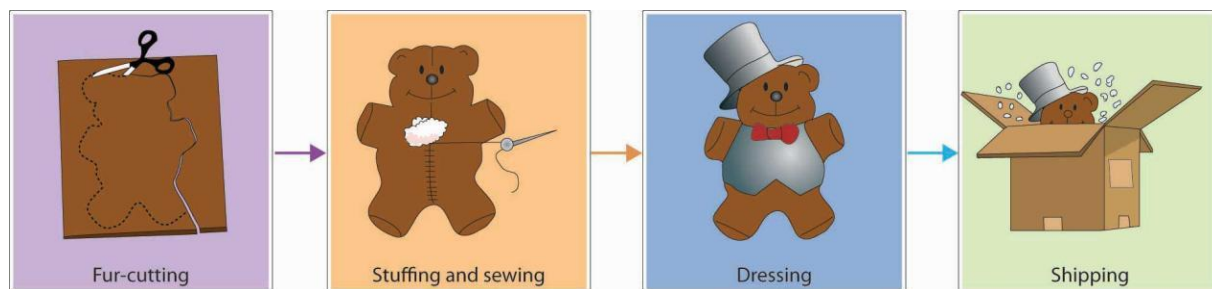


Figure 63 Process Layout at Vermont Teddy Bear Company

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*. Just Born, a candy maker located in Bethlehem, Pennsylvania, makes a product called Marshmallow Peeps on an assembly line. First, the ingredients are combined and whipped in huge kettles. Then, sugar is added for color. At the next workstation, the mixture—colored warm marshmallow—is poured into baby-chick-shaped molds carried on conveyor belts. The conveyor-belt parade of candy pieces

then moves forward to stations where workers add eyes or other details. When the finished candy reaches the packaging area, it's wrapped for shipment to stores around the world. To take an online tour of the Marshmallow Peeps production process, log on to the Just Born Web site at <https://www.justborn.com/who-we-are/how-our-candy-is-made> (or see Figure 3 "Product Layout at Just Born, Inc.").

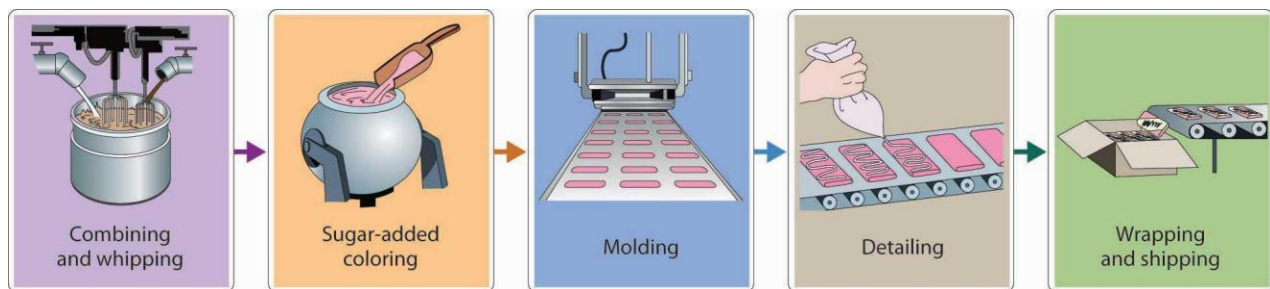


Figure 64 Product Layout at Just Born, Inc.

Both product and process layouts arrange work by *function*. At the Vermont Teddy Bear Company, for example, the cutting function is performed in one place, the stuffing-and-sewing function in another place, and the dressing function in a third place. If you're a cutter, you cut all day; if you're a sewer, you sew all day: that's your function. The same is true for the production of Marshmallow Peeps at Just Born: if your function is to decorate peeps, you stand on an assembly line and decorate all day; if your function is packing, you pack all day.

Arranging work by function, however, isn't always efficient. Production lines can back up, inventories can build up, workers can get bored with repetitive jobs, and time can be wasted in transporting goods from one workstation to another. To counter some of these problems, many manufacturers have adopted a cellular layout, in which small teams of workers handle all aspects of building a component, a "family" of components, or even a finished product. Each team works in a small area, or cell, equipped with everything that it needs to function as a self-contained unit. Machines are sometimes configured in a U-shape, with people working inside the U. Because team members often share duties, they're trained to perform several different jobs. Teams monitor both the quantity and the quality of their own output. This arrangement often results in faster completion time, lower inventory levels, improved quality, and better employee morale. Cellular manufacturing is used by large manufacturers, such as Boeing, Raytheon, and Pratt & Whitney,³²⁹ as well

as by small companies, such as Little Enterprise, which makes components for robots.³³⁰

Figure 4 "Cellular Layout" illustrates a typical cellular layout.

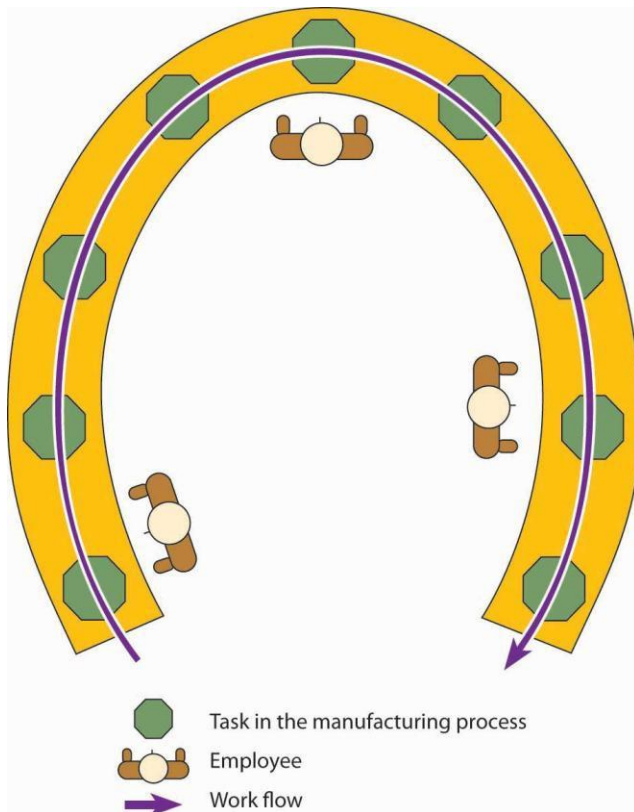


Figure 65 Cellular Layout

It's easy to move teddy bears and marshmallow candies around the factory while you're making them, but what about airplanes or ships? In producing large items, manufacturers use fixed-position layout in which the product stays in one place and the workers (and equipment) go to the product. This is the arrangement used by General Housing Corporation in constructing modular homes. Each house is constructed at the company's factory in Bay City, Michigan, according to the customer's design. Because carpenters, electricians, plumbers, and others work on each building inside the climate-controlled factory, the process can't be hindered by weather. Once

it's done, the house is transported in modules to the owner's building site and set up in one day. For a closer view of General Housing Corporation's production process, go to the General Housing Web site at <http://www.genhouse.com>.

Key Takeaways

- Managers have several production **layout** choices, including process, product, cellular, and fixed-position.
 - The **process layout** groups together workers or departments that perform similar tasks. At each position, workers use specialized equipment to perform a particular step in the production process.
 - In a **product layout**, high-volume goods are produced in assembly-line fashion—that is, a series of workstations at which already-made parts are assembled.

- In a **cellular layout**, small teams of workers handle all aspects of building a component, a “family of components,” or even a finished product.
- A **fixed-position layout** is used to make large items (such as ships or buildings) that stay in one place while workers and equipment go to the product.

Managing the Production Process in a Manufacturing Company

Learning Outcome

1. Identify the activities undertaken by the operations manager in overseeing the production process in a manufacturing company.

Once the production process is in place, the attention of the operations manager shifts to the daily activities of materials management, which encompass the following activities: purchasing, inventory control, and work scheduling.

Purchasing and Supplier Selection

The process of acquiring the materials and services to be used in production is called purchasing (or *procurement*). For many products, the costs of materials make up about 50 percent of total manufacturing costs. Not surprisingly, then, materials acquisition gets a good deal of the operations manager’s time and attention. As a rule, there’s no shortage of vendors willing to supply parts and other materials, but the trick is finding the *best* suppliers. In selecting a supplier, operations managers must consider such questions as the following:

- Can the vendor supply the needed quantity of materials at a reasonable price?
- Is the quality good?
- Is the vendor reliable (will materials be delivered on time)?
- Does the vendor have a favorable reputation?
- Is the company easy to work with?

Getting the answers to these questions and making the right choices—a process known as supplier selection—is a key responsibility of operations management.

E-Purchasing

Technology is changing the way businesses buy things. Through *e-purchasing* (or *e-procurement*), companies use the Internet to interact with suppliers. The process is similar to the one you'd use to find a consumer good—say, a forty-two-inch LCD high-definition TV—over the Internet. You might start by browsing the Web sites of TV manufacturers, such as Sony or Samsung, or electronics retailers, such as Best Buy. To gather comparative prices, you might go to a comparison-shopping Web site, such as Amazon.com, the world's largest online retailer. You might even consider placing a bid on eBay, an online marketplace where sellers and buyers come together to do business through auctions. Once you've decided where to buy your TV, you'd complete your transaction online, even paying for it electronically.

If you were a purchasing manager using the Internet to buy parts and supplies, you'd follow basically the same process. You'd identify potential suppliers by going directly to private Web sites maintained by individual suppliers or to public Web sites that collect information on numerous suppliers. You could do your shopping through online catalogs, or you might participate in an online marketplace by indicating the type and quantity of materials you need and letting suppliers bid on prices. (Some of these e-marketplaces are quite large. Covisint, for example, which was started by automakers to coordinate online transactions in the auto industry, is used by more than two hundred and fifty thousand suppliers in the auto industry, as well as suppliers in the health care field.)³³¹ Finally, just as you paid for your TV electronically, you could use a system called electronic data interchange (EDI) to process your transactions and transmit all your purchasing documents.

The Internet provides an additional benefit to purchasing managers by helping them communicate with suppliers and potential suppliers. They can use the Internet to give suppliers specifications for parts and supplies, encourage them to bid on future materials needs, alert them to changes in requirements, and give them instructions on doing business with their employers. Using the Internet for business purchasing cuts the costs of

purchased products and saves administrative costs related to transactions. And it's faster for procurement and fosters better communications.

Inventory Control

If a manufacturer runs out of the materials it needs for production, then production stops. In the past, many companies guarded against this possibility by keeping large inventories of materials on hand. It seemed like the thing to do at the time, but it often introduced a new problem—wasting money. Companies were paying for parts and other materials that they wouldn't use for weeks or even months, and in the meantime, they were running up substantial storage and insurance costs.

Most manufacturers have since learned that to remain competitive, they need to manage inventories more efficiently. This task requires that they strike a balance between two threats to productivity: losing production time because they've run out of materials, and wasting money because they're carrying too much inventory. The process of striking this balance is called inventory control, and companies now regularly rely on a variety of inventory-control methods.

Just-in-Time Production

One method is called just-in-time (JIT) production: the manufacturer arranges for materials to arrive at production facilities *just in time* to enter the manufacturing process. Parts and materials don't sit unused for long periods, and the costs of "holding" inventory are significantly cut. JIT, however, requires considerable communication and cooperation between the manufacturer and the supplier. The manufacturer has to know what it needs, and when. The supplier has to commit to supplying the right materials, of the right quality, at exactly the right time.

Material Requirements Planning

Another method, called material requirements planning (MRP), relies on a computerized program both to calculate the quantity of materials needed for production and to determine when they should be ordered or made. Let's say, for example, that you and several classmates are planning a fund-raising dinner for the local animal shelter. First, you estimate how many people will attend—say, fifty. Next, you plan the menu—lasagna, garlic bread, salad, and cookies. Then, you determine what ingredients you'll need to make the

food. Next, you have to decide when you'll need your ingredients. You don't want to make everything on the afternoon of the dinner; some things—like the lasagna and cookies—can be made ahead of time. Nor do you want to buy all your ingredients at the same time; in particular, the salad ingredients would go bad if purchased too far in advance. Once you've made all these calculations and decisions, you work out a schedule for the production of your dinner that indicates the order and timing of every activity involved. With your schedule in hand, you can determine when to buy each ingredient. Finally, you do your shopping.

Though the production process at most manufacturing companies is a lot more complex than planning a dinner (even for fifty), an MRP system is designed to handle similar problems. The program generates a production schedule based on estimated output (your food-preparation timetable for fifty guests), prepares a list of needed materials (your shopping list), and orders the materials (goes shopping).

The basic MRP focuses on material planning, but there's a more sophisticated system—called manufacturing resource planning (MRP II)—that goes beyond material planning to help monitor resources in all areas of the company. Such a program can, for instance, coordinate the production schedule with HR managers' forecasts for needed labor.

Work Scheduling

As we've seen, manufacturers make profits by transforming inputs (materials and other resources) into outputs (finished goods). We know, too, that production activities, like all business activities, have to be *controlled*: they have to be monitored to ensure that actual performance satisfies planned performance. In production, the control process starts when operations managers decide not only *which* goods and *how many* will be produced, but *when*. This detailed information goes into a master production schedule (MPS). To draw up an MPS, managers need to know where materials are located and headed at every step in the production process. For this purpose, they determine the *routing* of all materials—that is, the work flow of each item based on the sequence of operations in which it will be used.

Key Takeaways

- Once the production process is under way, the attention of the operations manager shifts to the daily activities of **materials management**, which encompasses **materials purchasing, inventory control**, and work scheduling.
- Because material costs often make up about 50 percent of total manufacturing costs, vendor selection and material acquisition gets a good deal of the operations manager's time and attention.
- In recent years, the purchasing function has been simplified through technology advances, including e-purchasing and **electronic data interchange (EDI)**, which process transactions and transmit purchasing documents.
- Commonly used inventory control methods include **just-in-time (JIT) production**, by which materials arrive just in time to enter the manufacturing process, and **material requirements planning (MRP)**, which uses computer programming to determine material needs.
- To schedule jobs, managers create a **master production schedule (MPS)**.

Graphical Tools: PERT and Gantt Charts

Learning Outcome

1. Explain how to create and use both PERT and Gantt charts.

Because they also need to control the timing of all operations, managers set up *schedules*: They select jobs to be performed during the production process, assign tasks to work groups, set timetables for the completion of tasks, and make sure that resources will be available when and where they're needed. There are a number of scheduling techniques. We'll focus on two of the most common—*Gantt* and *PERT charts*.

Gantt Charts

A Gantt chart, named after the designer, Henry Gantt, is an easy-to-use graphical tool that helps operations managers determine the status of projects. Let's say that you're in charge

Activity/Day	1	2	3	4	5	6	7	8	9	10	11	12	13
Cut fur	■	■											
Stuff and sew fur			■	■	■	■	■	■					
Cut material	■	■											
Sew clothes			■	■									
Embroider T-shirt					■	■							
Cut accessories	■												
Sew accessories		■	■										
Dress bears									■	■	■		
Package bears												■	
Ship bears													■

Lot size: 100 bears
 All activities are scheduled to begin at their earliest start time.
 ■ Completed work
 ■ Work to be completed

Figure 66 Gantt Chart for Vermont Teddy Bear

of making the “hiking bear” that we ordered earlier from the Vermont Teddy Bear Company. Figure 5 "Gantt Chart for Vermont Teddy Bear" is a Gantt chart for the production of one hundred of these bears. As you can see, it shows that several activities must be completed before the bears are dressed: the fur has to be cut, stuffed, and sewn; and the clothes and

accessories must be made. Our Gantt chart tells us that by day six, all accessories and clothing have been made. The stuffing and sewing, however (which must be finished before the bears are dressed), isn’t scheduled for completion until the end of day eight. As operations manager, you’ll have to pay close attention to the progress of the stuffing and sewing operations to ensure that finished products are ready for shipment by their scheduled date.

PERT Charts

Gantt charts are useful when the production process is fairly simple and the activities aren’t interrelated. For more complex schedules, operations managers may use PERT charts. PERT (which stands for *Program Evaluation and Review Technique*) is designed to diagram the activities required to produce a good, specify the time required to perform each activity in the process, and organize activities in the most efficient sequence. It also identifies a *critical path*: the sequence of activities that will entail the greatest amount of time. Figure 6 is a PERT diagram showing the same process for producing one “hiker” bear at Vermont Teddy Bear.



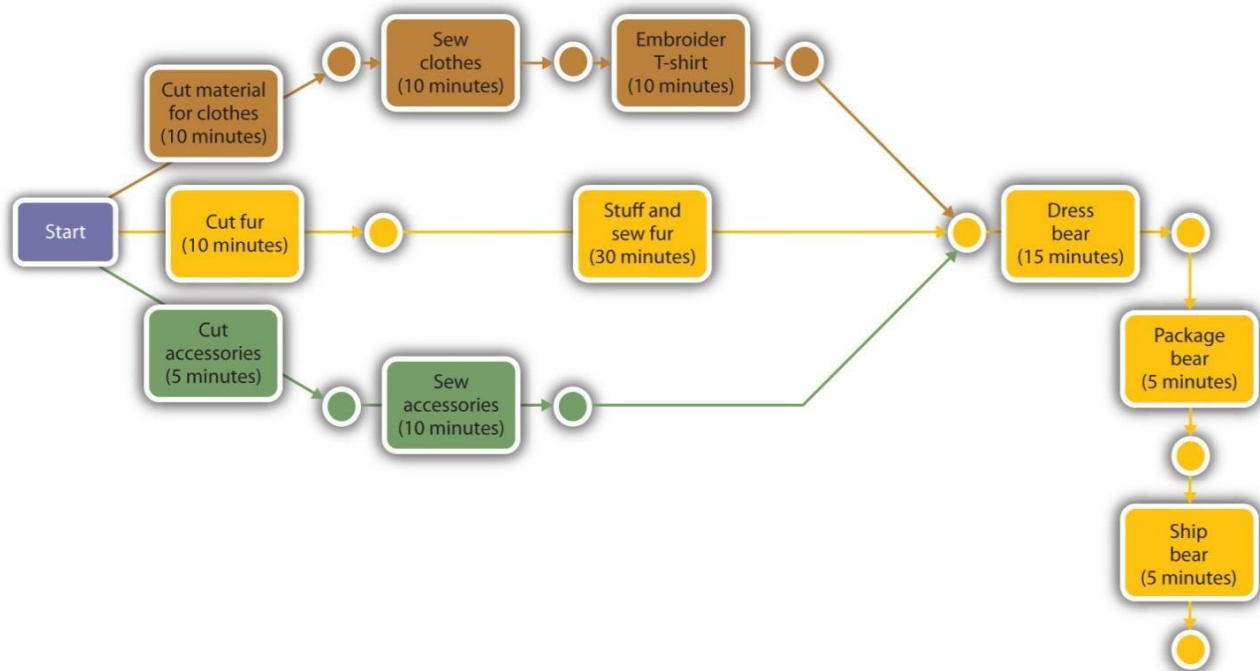


Figure 67 PERT Chart for Vermont Teddy Bear

Our PERT chart shows how the activities involved in making a single bear are related. It indicates that the production process begins at the cutting station. Next, the fur that's been cut for this particular bear moves first to the stuffing and sewing stations and then to the dressing station. At the same time that its fur is moving through this sequence of steps, the bear's clothes are being cut and sewn and its T-shirt is being embroidered. Its backpack and tent accessories are also being made at the same time. Note that fur, clothes, and accessories all meet at the dressing station, where the bear is dressed and outfitted with its backpack. Finally, the finished bear is packaged and shipped to the customer's house.

What was the critical path in this process? The path that took the longest amount of time was the sequence that included cutting, stuffing, dressing, packaging, and shipping—a sequence of steps taking sixty-five minutes. If you wanted to produce a bear more quickly, you'd have to save time on this path. Even if you saved the time on any of the other paths—say, the sequence of steps involved in cutting, sewing, and embroidering the bear's clothes—you still wouldn't finish the entire job any sooner: the finished clothes would just have to wait for the fur to be stuffed and sewn and moved to the dressing station. In other words, we can gain efficiency only by improving our performance on one or more of the activities along the critical path.

Key Takeaways

- Gantt and PERT charts are two of the most common graphical tools used by operations managers to diagram the activities involved in producing goods.
- A Gantt chart is an easy-to-use graphical tool that helps operations managers determine the status of projects.
- PERT charts are used to diagram the activities required to produce a good, specify the time required to perform each activity in the process, and organize activities in the most efficient sequence.
- A PERT chart identifies a critical path—the sequence of activities that will entail the greatest amount of time.

Operations Management for Service Providers

Learning Outcomes

1. List the characteristics that distinguish service operations from manufacturing operations.
2. Describe the decisions made in planning the product delivery process in a service company.
3. Identify the activities undertaken to manage operations in a service organization.

As the U.S. economy has changed from a goods producer to a service provider, the predominance of the manufacturing sector has declined substantially over the last sixty years. Today, only about 9 percent of U.S. workers are employed in manufacturing, in contrast to 30 percent in 1950.³³² Most of us now hold jobs in the service sector, which accounts for 77 percent of U.S. gross domestic product.³³³ Wal-Mart is now America's largest employer, followed by IBM, United Parcel Service (UPS), McDonald's, and Target. Not until we drop down to the seventh-largest employer—Hewlett Packard—do we find a company with even a manufacturing component.³³⁴

Though the primary function of both manufacturers and service providers is to satisfy

customer needs, there are several important differences between the two types of operations. Let's focus on three of them:

1. *Intangibility.* Manufacturers produce tangible products—things that can be touched or handled, such as automobiles and appliances. Service companies provide intangible products, such as banking, entertainment, or education.
2. *Customization.* Manufactured goods are generally standardized; one twelve-ounce bottle of Pepsi is the same as any other twelve-ounce bottle of Pepsi. Services, by contrast, are often customized to satisfy the specific needs of a customer. When you go to the barber or the hairdresser, you ask for a haircut that looks good on you because of the shape of your face and the texture of your hair. When you go to the dentist, you ask him or her to fill or pull the tooth that's bothering you.
3. *Customer contact.* You could spend your entire working life assembling cars in Detroit and never meet a customer who bought a car that you helped to make. But if you were a waitress, you'd interact with customers every day. In fact, their satisfaction with your product would be determined in part by the service that you provided. Unlike manufactured goods, many services are bought and consumed at the same time.

Not surprisingly, operational efficiency is just as important in service industries as it is in manufacturing. To get a better idea of the role of operations management in the service sector, we'll look closely at Burger King (BK), home of the Whopper, and the world's second-largest restaurant chain.³³⁵

BK has grown substantially since selling the first Whopper (for \$0.37) almost half a century ago. The instant success of the

fire-grilled burger encouraged the Miami founders of the company to expand by selling franchises. Today, there are 12,200 BK company- and independently-owned franchised restaurants in seventy-three countries (seven thousand of which are in the United States),

Saylor URL: <http://www.saylor.org/books>



Edited 2022: Tillamook Bay Community College



Figure 68 Here is just one of the over twelve thousand Burger King restaurants across the globe.

Saylor.org

341

and they employ almost forty thousand people.³³⁶ More than eleven million customers visit BK each day.³³⁷

Operations Planning

When starting or expanding operations, businesses in the service sector must make a number of decisions quite similar to those made by manufacturers:

- What services (and perhaps what goods) should they offer?
- How will they provide these services?
- Where will they locate their business, and what will their facilities look like?
- How will they forecast demand for their services?

Let's see how service firms like BK answer questions such as these.³³⁸

Operations Processes

Service organizations succeed by providing services that satisfy customers' needs.

Companies that provide transportation, such as airlines, have to get customers to their destinations as quickly and safely as possible. Companies that deliver packages, such as FedEx, must pick up, sort, and deliver packages in a timely manner. Colleges must provide quality educations. Companies that provide both services and goods, such as Domino's Pizza, have a dual challenge: they must produce a quality well and deliver it satisfactorily.

Service providers that produce goods can, like manufacturers, adopt either a *make-to-order* or a *make-to-stock* approach to manufacturing them. BK, which encourages patrons to customize burgers and other menu items, uses a make-to-order approach. BK can customize products because it builds sandwiches one at a time rather than batch-process them. Meat patties, for example, go from the grill to a steamer for holding until an order comes in. Then the patty is pulled from the steamer and requested condiments are added. Finally, the completed sandwich chutes to a counter worker, who gives it to the customer. In contrast, many of BK's competitors, including McDonald's, rely on a make-to-stock approach in which a number of sandwiches are made at the same time with the same condiments. If a customer wants, say, a hamburger without onions, he or she has to wait for a new batch of patties to be grilled. The procedure could take up to five minutes,

whereas BK can process a special order in thirty seconds.

Like manufacturers, service providers must continuously look for ways to improve operational efficiency. Throughout its sixty-year history, BK has introduced a number of innovations that have helped make the company (as well as the fast-food industry itself) more efficient. BK, for example, was the first to offer drive-through service (which now accounts for 70 percent of its sales)³³⁹.

It was also a BK vice president, David Sell, who came up with the idea of moving the drink station from behind the counter so that customers could take over the time-consuming task of filling cups with ice and beverages. BK was able to cut back one employee per day at every one of its more than eleven thousand restaurants. Material costs also went down because customers usually fill cups with more ice, which is cheaper than a beverage. Moreover, there were savings on supply costs because most customers don't bother with lids, and many don't use straws. On top of everything else, most customers liked the system (for one thing, it allowed them to customize their own drinks by mixing beverages), and as a result, customer satisfaction went up, as well. Overall, the new process was a major success and quickly became the industry standard.

Facilities

When starting or expanding a service business, owners and managers must invest a lot of time in selecting a location, determining its size and layout, and forecasting demand. A poor location or a badly designed facility can cost customers, and inaccurate estimates of demand for products can result in poor service, excessive costs, or both.

Site Selection

People in the real estate industry often say that the three most important factors to consider when you're buying a home are location, location, location. The same principle applies when you're trying to locate a service business. To be successful in a service industry, you need to be accessible to your customers. Some service businesses, such as cable-TV providers, package-delivery services, and e-retailers, go to their customers. Many others, however—hotels, restaurants, stores, hospitals, and airports—have to attract customers to their facilities. These businesses must locate where there's a high volume of available customers. Let's see how BK decides where to place a restaurant. "Through the

light and to the right.” This is a favorite catchphrase among BK planners who are looking for a promising spot for a new restaurant (at least in the United States). In picking a location, BK planners perform a detailed analysis of demographics and traffic patterns, yet the most important factor is usually *traffic count*—the number of cars or people that pass by a specific location in the course of a day. In the United States, where we travel almost everywhere by car, BK looks for busy intersections, interstate interchanges with easy off and on ramps, or such “primary destinations” as shopping malls, tourist attractions, downtown business areas, or movie theaters. In Europe, where public transportation is much more common, planners focus on subway, train, bus, and trolley stops.

Once planners find a site with an acceptable traffic count, they apply other criteria. It must, for example, be easy for vehicles to enter and exit the site, which must also provide enough parking to handle projected dine-in business. Local zoning must permit standard signage, especially along interstate highways. Finally, expected business must be high enough to justify the cost of the land and building.

Size and Layout

Because manufacturers do business out of plants rarely visited by customers, they base the size and layout of their facilities solely on production needs. In the service sector, however, most businesses must design their facilities with the customer in mind: they must accommodate the needs of their customers while keeping costs as low as possible. Performing this twofold task isn’t easy. Let’s see how BK has met the challenge.

For its first three decades, almost all BK restaurants were pretty much the same. They all sat on one acre of land (located “through the light and to the right”), had about four thousand square feet of space, and held seating for seventy customers. All kitchens were roughly the same size. As long as land was cheap and sites were readily available, this system worked well enough. By the early 1990s, however, most of the prime sites had been taken, if not by BK itself, then by one of its fast-food competitors or other businesses needing a choice spot, including gas stations and convenience stores. With everyone bidding on the same sites, the cost of a prime acre of land had increased from \$100,000 to over \$1 million in a few short years.

To continue growing, BK needed to change the way it found and developed its locations.

Planners decided that they had to find ways to reduce the size of a typical BK restaurant. For one thing, they could reduce the number of seats, because the business at a typical outlet had shifted over time from 90 percent inside dining and 10 percent drive-through to a 50-50 split. BK customers tended to be in a hurry, and more customers preferred the convenience of drive-through “dining.”

David Sell (the same executive who had recommended letting customers fill their own drink cups) proposed to save space by wrapping Whoppers in paper instead of serving them in the cardboard boxes that took up too much space in the back room of every restaurant. So BK switched to a single paper wrapper with the label “Whopper” on one side and “Cheese Whopper” on the other. To show which product was inside, employees just folded the wrapper in the right direction. Ultimately, BK replaced pallets piled high with boxes with a few boxes full of wrappers.

Ideas like these helped BK trim the size of a restaurant from four thousand square feet to as little as one thousand. In turn, smaller facilities enabled the company to enter markets that were once cost prohibitive. Now BK could locate profitably in airports, food courts, strip malls, center-city areas, and even schools. The company even designed 10-foot-by-10-foot kiosks that could be transported to special events, stadiums, and concerts.

Capacity Planning

Estimating capacity needs for a service business isn't the same thing as estimating those of a manufacturer. A manufacturer can predict overall demand, produce the product, store it in inventory, and ship it to a customer when it's ordered. Service providers, however, can't store their products for later use: hairdressers can't “inventory” haircuts, hospitals can't “inventory” operations, and amusement parks can't “inventory” roller-coaster rides. Service firms have to build sufficient capacity to satisfy customers' needs on an “as-demanded” basis. Like manufacturers, service providers must consider many variables when estimating demand and capacity:

- How many customers will I have?
- When will they want my services (which days of the week, which times of the day)?
- How long will it take to serve each customer?
- How will external factors, such as weather or holidays, affect the demand for my

services?

Forecasting demand is easier for companies like BK, which has a long history of planning facilities, than for brand-new service businesses. BK can predict sales for a new restaurant by combining its knowledge of customer-service patterns at existing restaurants with information collected about each new location, including the number of cars or people passing the proposed site and the effect of nearby competition.

Managing Operations

Overseeing a service organization puts special demands on managers, especially those running firms, such as hotels, retail stores, and restaurants that have a high degree of contact with customers. Service firms provide customers with personal attention and must satisfy their needs in a timely manner. This task is complicated by the fact that demand can vary greatly over the course of any given day. Managers, therefore, must pay particular attention to employee work schedules and (in some cases) inventory management. Let's see how BK deals with these problems.

Scheduling

In manufacturing, managers focus on scheduling the *activities* needed to transform raw materials into finished goods. In service organizations, they focus on scheduling *workers* so that they're available to handle fluctuating customer demand. Each week, therefore, every BK store manager schedules employees to cover not only the peak periods of breakfast, lunch, and dinner, but also the slower periods in between. If he or she staffs too many people, labor cost per sales dollar will be too high. If there aren't enough employees, customers have to wait in lines. Some get discouraged, and even leave, and many may never come back.

Scheduling is made easier by information provided by a point-of-sale device built into every BK cash register. The register keeps track of every sandwich, beverage, and side order sold by the hour, every hour of the day, every day of the week. Thus, to determine how many people will be needed for next Thursday's lunch hour, the manager reviews last Thursday's data, using sales revenue and a specific BK formula to determine the appropriate staffing level. Each manager can adjust this forecast to account for other factors, such as current marketing promotions or a local sporting event that will increase

customer traffic.

Inventory Control

Businesses that provide both goods and services, such as retail stores and auto-repair shops, have the same inventory-control problems as manufacturers: keeping levels too high costs money, while running out of inventory costs sales. Technology, such as the point-of-sale registers used at BK, makes the job easier. BK's system tracks everything sold during a given time and lets each store manager know how much of everything should be kept in inventory. It also makes it possible to count the number of burgers and buns, bags and racks of fries, and boxes of beverage mixes at the beginning or end of each shift. Because there are fixed numbers of supplies—say, beef patties or bags of fries—in each box, employees simply count boxes and multiply. In just a few minutes, the manager knows whether the inventory is correct (and should be able to see if any theft has occurred on the shift).

Key Takeaways

- Though the primary function of both manufacturers and service providers is to satisfy customer needs, there are several important differences between the two types of operations.
- While manufacturers produce tangible, generally standardized products, service firms provide intangible products that are often customized to satisfy specific needs. Unlike manufactured goods, many services are bought and consumed at the same time.
- Operational efficiency is just as important in service industries as it is in manufacturing.
- Operations managers in the service sector make many decisions that are similar to those made by manufacturers: they decide which services to offer, how to provide these services, where to locate their businesses, what their facilities will look like, and what the demand will be for their services.
- Estimating **capacity** needs for a service business is more difficult than for a manufacturer. Service providers can't store their services for later use: services must be delivered on an as-needed basis.

- Service providers that produce goods can, like manufacturers, adopt either a make-to-order approach (in which products are made to customer satisfaction) or make-to-stock approach (in which products are made for inventory) to manufacturing them.
- Overseeing a service organization puts special demands on managers, especially services requiring a high degree of contact with customers.
- Given the importance of personalized service, scheduling workers is more complex in the service industry than in manufacturing. In manufacturing, operations managers focus on scheduling the *activities* needed to produce goods; in service organizations, they focus on scheduling *workers* to ensure that enough people are available to handle fluctuating customer demand.

Producing for Quality

Learning Outcome

1. Explain how manufacturing and service companies alike use total quality management and outsourcing to provide value to customers.

What do you do if you get it home and your brand-new DVD player doesn't work? What if you were late for class because it took you twenty minutes to get a burger and order of fries at the drive-through window of a fast-food restaurant? Like most people, you'd probably be more or less disgruntled. As a customer, you're constantly assured that when products make it to market, they're of the highest possible quality, and you tend to avoid brands that have failed to live up to your expectations or to producers' claims. You're told that workers in such businesses as restaurants are there to serve you, and you probably don't go back to establishments where you've received poor-quality service.

But 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."³⁴⁰ When you buy a DVD player, you expect it to play DVDs. When it doesn't, you question its quality. When you go to a drive-through window, you expect to be served in a reasonable amount of time. If you're forced to wait, you conclude that you're the victim of

poor-quality service.

Quality Management

To compete today, companies must deliver quality goods and services that satisfy customers' needs. This is the objective of quality management. Total quality management (TQM), or quality assurance, includes all the steps that a company takes to ensure that its goods or services are of sufficiently high quality to meet customers' needs. Generally speaking, a company adheres to TQM principles by focusing on three tasks:

1. Customer satisfaction
2. Employee involvement
3. Continuous improvement

Let's take a closer look at these three principles.

Customer Satisfaction

Companies that are committed to TQM understand that the purpose of a business is to generate a profit by satisfying customer needs. Thus, they let their customers define *quality* by identifying and offering those product features that satisfy customer needs. They encourage customers to tell them how to make the right products, both goods and services that work the right way.

Armed with this knowledge, they take steps to make sure that providing quality is a factor in every facet of their operations—from design, to product planning and control, to sales and service. To get feedback on how well they're doing, many companies routinely use surveys and other methods to monitor customer satisfaction. By tracking the results of feedback over time, they can see where they need to improve.

Employee Involvement

Successful TQM requires that everyone in the organization, not simply upper-level management, commits to satisfying the customer. When customers wait too long at a drive-through window, it's the responsibility of a number of employees, not the manager alone. A defective DVD isn't solely the responsibility of the manufacturer's quality control department; it's the responsibility of every employee involved in its design, production, and even shipping. To get everyone involved in the drive for quality assurance, managers must

communicate the importance of quality to subordinates and motivate them to focus on customer satisfaction. Employees have to be properly trained not only to do their jobs but also to detect and correct quality problems. In many companies, employees who perform similar jobs work as teams, sometimes called quality circles, to identify quality, efficiency, and other work-related problems, to propose solutions, and to work with management in implementing their recommendations.

Continuous Improvement

An integral part of TQM is continuous improvement: the commitment to making constant improvements in the design, production, and delivery of goods and services. Improvements can almost always be made to increase efficiency, reduce costs, and improve customer service and satisfaction. Everyone in the organization is constantly on the lookout for ways to do things better.

Statistical Process Control

Companies can use a variety of tools to identify areas for improvement. A common approach in manufacturing is called statistical process control. This technique monitors production quality by testing a sample of output to see whether goods in process are being made according to predetermined specifications.

Assume for a moment that you work for Kellogg's, the maker of Raisin Bran cereal. You know that it's the company's goal to pack two scoops of raisins in every box of cereal. How can you test to determine whether this goal is being met? You could use a statistical process control method called a *sampling distribution*. On a periodic basis, you would take a box of cereal off the production line and measure the amount of raisins in the box. Then you'd record that amount on a *control chart* designed to compare actual quantities of raisins with the desired quantity (two scoops). If your chart shows that several samples in a row are low on raisins, you'd shut down the production line and take corrective action.

Benchmarking

Sometimes it also helps to look outside the organization for ideas on how to improve operations and to learn how your company compares with others. Companies routinely use benchmarking to compare their performance on a number of dimensions with the performance of other companies that excel in particular areas. Frequent benchmark

targets include L.L. Bean, for its superior performance in filling orders; 3M, for its record of introducing innovative products; Motorola, for its success in maintaining consistent quality standards; and Mary Kay Cosmetics, for its skills in inventory control.³⁴¹

International Quality Standards

As a consumer, wouldn't you like to know which companies ensure that their products meet quality specifications? Some of us would like 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 know? It might be worth your while to find out whether your suppliers were also 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 this kind of information. 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.³⁴² ISO certification has become an internationally recognized symbol of quality management and is almost essential to be competitive in the global marketplace.

Outsourcing

PowerSki's Web site states that "PowerSki International has been founded to bring a new watercraft, the PowerSki Jetboard, and the engine technology behind it, to market."³⁴³ That goal was reached in May 2003, when the firm emerged from a lengthy design period. Having already garnered praise for its innovative product, PowerSki was ready to begin mass-producing Jetboards. At this juncture, the management team made a strategic decision that's not uncommon in manufacturing today. Rather than producing Jetboards in-house, they opted for outsourcing: having outside vendors manufacture the engines, fiberglass hulls, and associated parts. Assembly of the final product took place in a manufacturing facility owned by All American Power Sports in Moses Lake, Washington. This decision doesn't mean that the company relinquished control over quality; in fact, every component that goes into the PowerSki Jetboard is manufactured to exact specifications set by PowerSki. One advantage of outsourcing its production function is that the management team can thereby devote its attention to refining its product design and designing future products.

Outsourcing in the Manufacturing Sector

Understandably, outsourcing is becoming an increasingly popular option among manufacturers. For one thing, few companies have either the expertise or the inclination to produce everything needed to make a product. Today, more firms, like PowerSki, want to specialize in the processes that they perform best—and outsource the rest. Like PowerSki, they also want to take advantage of outsourcing by linking up with suppliers located in regions with lower labor costs.



Figure 69 Outsourcing the production of its engines, hulls, and other components enables PowerSki to reduce the cost of producing each Jetboard through manufacturing efficiencies and lower labor costs. All components that go into the Jetboard are made to PowerSki's specifications and are inspected upon arrival to ensure that they meet the company's high-quality standards.

Outsourcing in the Service Sector

Outsourcing is by no means limited to the manufacturing sector. Service companies also outsource many of their noncore functions. Your school, for instance, probably outsources

such functions as food services, maintenance, bookstore sales, printing, grounds keeping, security, information-technology (IT) support, and even residence operations.

Key Takeaways

- Today, companies that compete in both the manufacturing and service sectors must deliver **quality** goods and services that satisfy customers' needs. Many companies achieve this goal by adhering to principles of **total quality management (TQM)**.
- Companies using a TQM approach focus on customer satisfaction, engage all members of the organization in quality efforts, and strive for **continuous improvement** in the design, production, and delivery of goods and services. They also **benchmark** other companies to find ways to improve their own performance.
- To identify areas for improvement, companies can use a technique called **statistical process control (SPC)**, which monitors quality by testing to see whether a sample of output is being made to predetermined specifications.
- Another cost-saving approach is **outsourcing**—having outside vendors manufacture components or even entire products or provide services, such as information- technology support or service center operations.
- Outsourcing is an appealing option for companies without the expertise in producing everything needed to make a product or those that want to take advantage of low labor costs in developing countries.

Chapter 11 Review Questions

Multiple Choice:

- This operations manager's responsibility involves efforts to ensure that goods are produced according to specifications.
 1. Production planning
 2. Production control
 3. Quality control
- A print or sign shop company produces using this strategy.
 1. Make-to-order
 2. Mass production
 3. Mass customization
- One of the best known companies that uses this production strategy is Nike.
 1. Make-to-order
 2. Mass production
 3. Mass customization
- _____ charts are an easy-to-use graphical tool that helps operations managers determine the status of projects.
 1. GANTT
 2. PERT
 3. MPS
 4. MRP
- This quality management technique focuses on the commitment to making constant improvements in the design, production, and delivery of goods and services.
 1. ISO 9000.
 2. Benchmarking.
 3. Statistical Process Control
 4. TQM

Short Answer:

1. During production planning, explain what three (3) things do managers determine.
2. Describe the four (4) production layout choices.
3. Describe the three (3) tasks a company adheres to when focusing on TQM principles.

Chapter 12 The Role of Accounting in Business

The Role of Accounting

Learning Outcomes

1. Define accounting and explain the differences between managerial accounting and financial accounting.
2. Identify some of the users of accounting information and explain how they use it.

Accounting is often called “the language of business.” Why? Because it *communicates* so much of the information that owners, managers, and investors need to evaluate a company’s financial performance. These people are all stakeholders in the business—they’re interested in its activities because they’re affected by them. In fact, the purpose of accounting is to help stakeholders make better business decisions by providing them with financial information. Obviously, you wouldn’t try to run an organization or make investment decisions without accurate and timely financial information, and it’s the accountant who prepares this information. More importantly, accountants make sure that stakeholders understand the *meaning* of financial information, and they work with both individuals and organizations to help them use financial information to deal with business problems. Actually, collecting all the numbers is the easy part—today, all you have to do is start up your accounting software. The hard part is analyzing, interpreting, and communicating the information. Of course, you also have to present everything clearly while effectively interacting with people from every business discipline. In any case, we’re now ready to define accounting as the process of measuring and summarizing business activities, interpreting financial information, and communicating the results to management and other decision makers.

Fields of Accounting

Accountants typically work in one of two major fields. *Management accountants* provide information and analysis to decision makers *inside* the organization in order to help them run it. *Financial accountants* furnish information to individuals and groups *both inside and*

outside the organization in order to help them assess its financial performance. In other words, management accounting helps you keep your business running while financial accounting tells you how well you're running it.

Management Accounting

Management accounting plays a key role in helping managers carry out their responsibilities. Because the information that it provides is intended for use by people who perform a wide variety of jobs, the format for reporting information is flexible. Reports are tailored to the needs of individual managers, and the purpose of such reports is to supply *relevant, accurate, timely information* in a format that will aid managers in making decisions. In preparing, analyzing, and communicating such information, accountants work with individuals from all the *functional areas* of the organization—human resources, operations, marketing, and finance.

Financial Accounting

Financial accounting is responsible for preparing the organization's financial statements—including the *income statement*, the *statement of owner's equity*, the *balance sheet*, and the *statement of cash flows*—that summarize a company's past performance and evaluate its current financial condition. In preparing financial statements, financial accountants adhere to a uniform set of rules called generally accepted accounting principles (GAAP)—the basic principles for financial reporting issued by an independent agency called the Financial Accounting Standards Board (FASB). Users want to be sure that financial statements have been prepared according to GAAP because they want to be sure that the information reported in them is accurate. They also know that they can compare the statements issued by one company to those of another company in the same industry.

While companies headquartered in the United States follow U.S.-based GAAP, many companies located outside the United States follow a different set of accounting principles called International Financial Reporting Standards (IFRS). These multinational standards, which are issued by the International Accounting Standards Board (IASB), differ from U.S. GAAP in a number of important ways. IFRS, for example, is a little stricter about the ways you can calculate the costs of inventory, but we're not going to dwell unnecessarily on such fine distinctions. Bear in mind, however, that, according to most experts, a single set

of worldwide standards will eventually emerge to govern the accounting practices of both U.S. and non-U.S. companies.

Who Uses Financial Accounting Information?

The users of *managerial* accounting information are pretty easy to identify—basically, they're a firm's *managers*. We need to look a little more closely, however, at the users of *financial* accounting information, and we also need to know a little more about what they do with the information that accountants provide them.

Owners and Managers

In summarizing the outcomes of a company's financial activities over a specified period of time, financial statements are, in effect, report cards for owners and managers. They show, for example, whether the company did or didn't make a profit and furnish other information about the firm's financial condition. They also provide information that managers and owners can use in order to take corrective action.

Investors and Creditors

If you loaned money to a friend to start a business, wouldn't you want to know how the business was doing? Investors and creditors furnish the money that a company needs to operate, and not surprisingly, they feel the same way. Because they know that it's impossible to make smart investment and loan decisions without accurate reports on an organization's financial health, they study financial statements to assess a company's performance and to make decisions about continued investment.

According to the world's most successful investor (and third-richest individual), Warren Buffett, the best way to prepare yourself to be an investor is to learn all the accounting you can. Buffett, chairman and CEO of Berkshire Hathaway, a company that invests in other companies, turned an original investment of \$10,000 into a net worth of \$35 billion in four decades, and he did it, in large part, by paying close attention to financial accounting reports.³⁴⁴

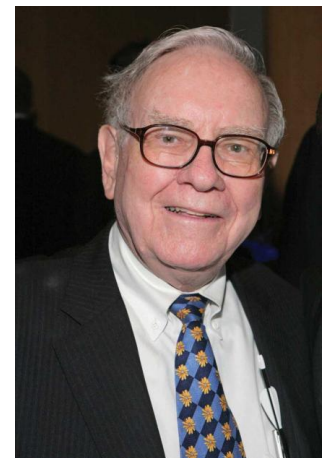


Figure 70 Warren Buffett: Photo by Kevin Parry /WireImage/Getty Images

Government Agencies

Businesses are required to furnish financial information to a number of government

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agencies. Publicly owned companies, for example—the ones whose shares are traded on a stock exchange—must provide annual financial reports to the Securities and Exchange Commission (SEC), a federal agency that regulates stock trades. Companies must also provide financial information to local, state, and federal taxing agencies, including the Internal Revenue Service.

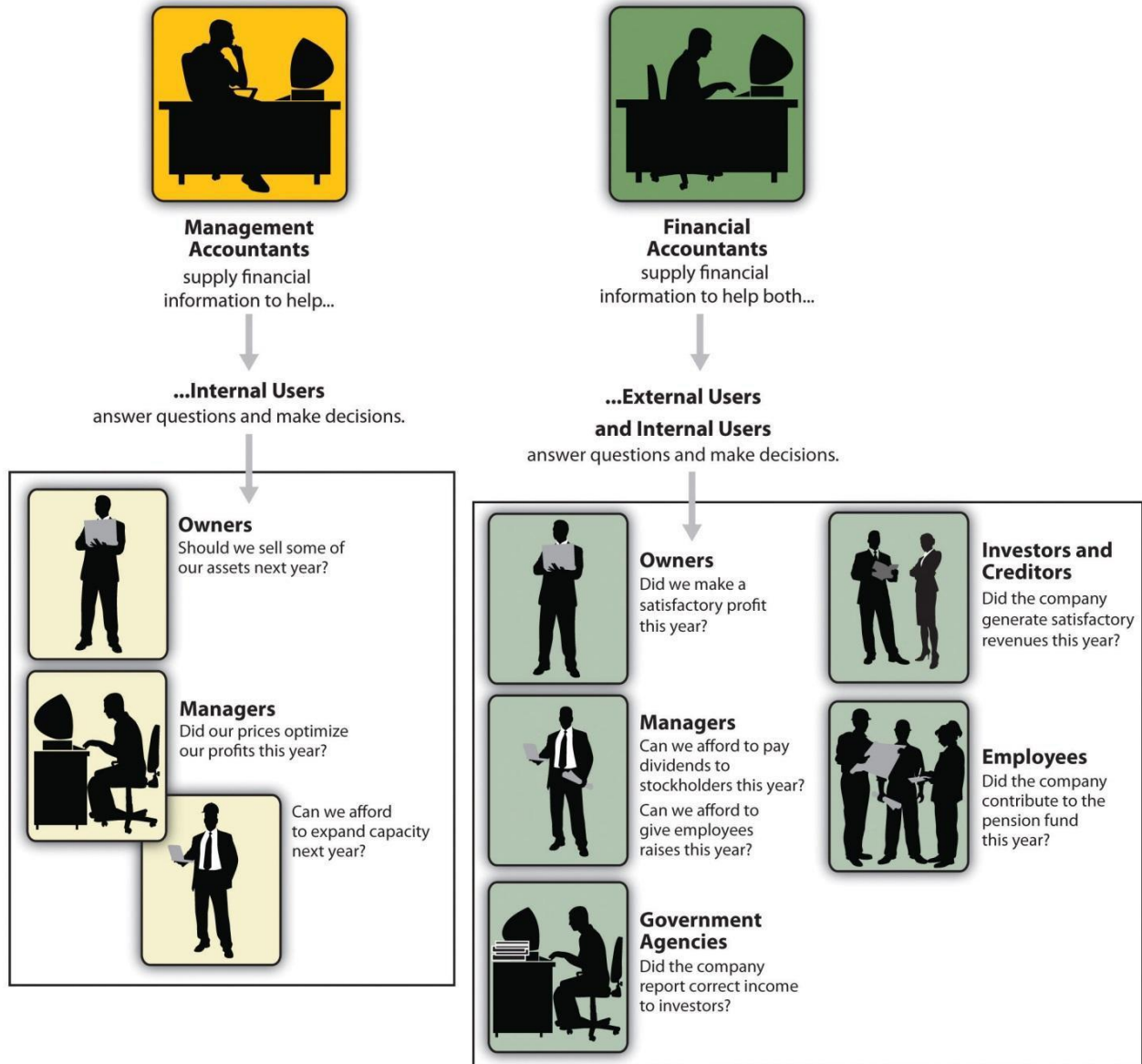


Figure 71 Management and Financial Accounting

Other Users

A number of other external users have an interest in a company's financial statements.

Suppliers, for example, need to know if the company to which they sell their goods is

having trouble paying its bills or may even be at risk of going under. Employees and labor

unions are interested because salaries and other forms of compensation are dependent on an employer's performance.

Figure 2 "Management and Financial Accounting" summarizes the main differences between the users of management and financial accounting and the types of information issued by accountants in the two areas. In the rest of this chapter, we'll learn how to prepare a set of financial statements and how to interpret them. We'll also discuss issues of ethics in the accounting communities and career opportunities in the accounting profession.

Key Takeaways

- **Accounting** is a system for measuring and summarizing business activities, interpreting financial information, and communicating the results to management and other **stakeholders** to help them make better business decisions.
- Accounting can be divided into two major fields:
 1. **Management accounting** provides information and analysis to decision makers *inside* the organization (such as owners and managers) to help them operate the business.
 2. **Financial accounting** provides information not only to internal managers, but also to people *outside* the organization (such as investors, creditors, government agencies, suppliers, employees, and labor unions) to assist them in assessing a firm's financial performance.
- U.S. and non-U.S. companies follow different sets of standards in preparing financial accounting reports:
- U.S. companies adhere to a uniform set of rules called **generally accepted accounting principles (GAAP)**, which are issued by an independent agency called the Financial Accounting Standards Board (FASB).

- Many companies outside the United States follow a set of accounting principles called **International Financial Reporting Standards (IFRS)**, which are issued by the International Accounting Standards Board (IASB).
- Experts expect that a single set of worldwide accounting standards will eventually emerge and be followed by both U.S. and non-U.S. companies.

Understanding Financial Statements

Learning Outcomes

1. Understand the function of the income statement.
2. Understand the function of the balance sheet.
3. Understand the function of the statement of owner's equity.

We hope that, so far, we've made at least one thing clear: If you're in business, you need to understand financial statements. For one thing, the law no longer allows high-ranking executives to plead ignorance or fall back on delegation of authority when it comes to taking responsibility for a firm's financial reporting. In a business environment tainted by episodes of fraudulent financial reporting and other corporate misdeeds, top managers are now being held accountable (so to speak) for the financial statements issued by the people who report to them. For another thing, top managers need to know if the company is hitting on all cylinders or sputtering down the road to bankruptcy. To put it another way (and to switch metaphors): if he didn't understand the financial statements issued by the company's accountants, an executive would be like an airplane pilot who doesn't know how to read the instrument in the cockpit—he might be able keep the plane in the air for a while, but he wouldn't recognize any signs of impending trouble until it was too late.

The Function of Financial Statements

Put yourself in the place of the woman in Figure 3 "What Connie Wants to Know". She runs Connie's Confections out of her home. She loves what she does, and she feels that she's doing pretty well. In fact, she has an opportunity to take over a nearby store at very reasonable rent, and she can expand by getting a modest bank loan and investing some more of her own money. So it's decision time for Connie: She knows that the survival rate for start-ups isn't very good, and before taking the next step, she'd like to get a better idea

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of whether she's actually doing well enough to justify the risk. As you can see, she has several pertinent questions. We aren't privy to Connie's finances, but we can tell her how basic financial statements will give her some answers.³⁴⁵

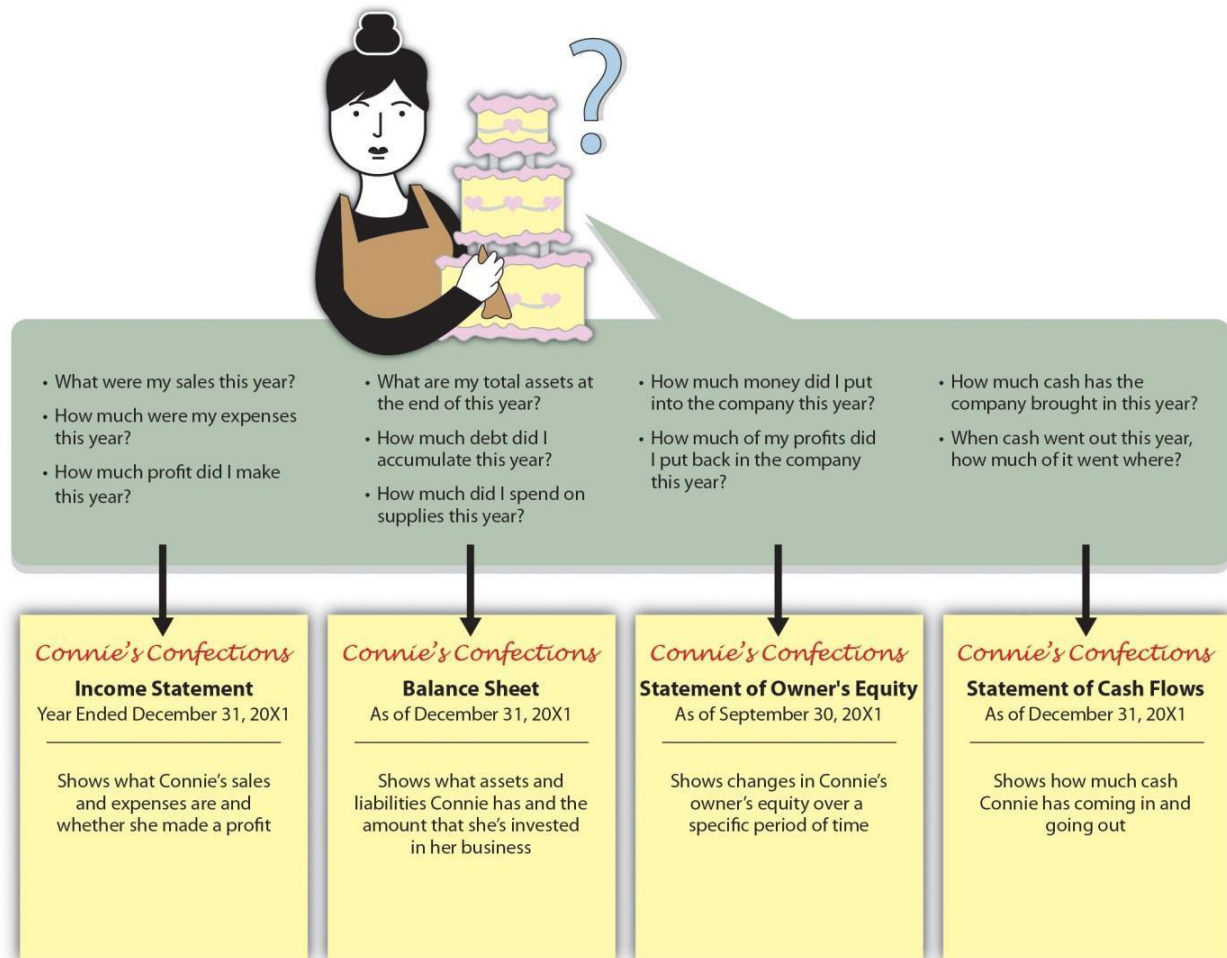


Figure 72 What Connie Wants to Know

Toying with a Business Idea

We know what you're thinking: It's nice to know that accounting deals with real-life situations, but while you wish Connie the best, you don't know enough about the confectionary business to appreciate either the business decisions or the financial details. Is there any way to bring this lesson a little closer to home? Besides, while knowing what financial statements will tell you is one thing, you want to know how to *prepare* them.

Agreed. So let's assume that you need to earn money while you're in college and that you've decided to start a small business. Your business will involve selling stuff to other college students, and to keep things simple, we'll assume that you're going to operate on a

“cash” basis: you’ll pay for everything with cash, and everyone who buys something from you will pay in cash.

A Word about Cash. You probably have at least a little *cash* on you right now—some currency, or paper money, and coins. In accounting, however, the term *cash* refers to more than just paper money and coins. It also refers to the money that you have in checking and savings accounts and includes items that you can deposit in these accounts, such as money orders and different types of checks.

Your first task is to decide exactly what you’re going to sell. You’ve noticed that with homework, exams, social commitments, and the hectic lifestyle of the average college student, you and most of the people you know always seem to be under a lot of stress. Sometimes you wish you could just lie back between meals and bounce a ball off the wall. And that’s when the idea hits you: Maybe you could make some money by selling a product called the “Stress-Buster Play Pack.” Here’s what you have in mind: you’ll buy small toys and other fun stuff—instant stress relievers—at a local dollar store and pack them in a rainbow-colored plastic treasure chest labeled “Stress-Buster.”

And here’s where you stand: You have enough cash to buy a month’s worth of plastic treasure chests and toys. After that, you’ll use the cash generated from sales of Stress-Buster Play Packs to replenish your supply. Each plastic chest will cost \$1.00, and you’ll fill each one with a variety of five of the following toys, all of which you can buy for \$1.00 each:

- A happy face stress ball
- A roomarang (an indoor boomerang)
- Some silly putty
- An inflatable beach ball
- A coil “slinky” spring
- A paddle-ball game
- A ball for bouncing off walls

You plan to sell each Stress-Buster Play Pack for \$10 from a rented table stationed outside a major dining hall. Renting the table will cost you \$20 a month. Because your own

grades aren't what your parents and the dean would like them to be, you decide to hire fellow students (trustworthy people with better grades than yours) to staff the table at peak traffic periods. They'll be on duty from noon until 2:00 p.m. each weekday, and you'll pay them \$6 an hour. Wages, therefore, will cost you \$240 a month (2 hours × 5 days × 4 weeks = 40 hours × \$6). Finally, you'll run ads in the college newspaper at a monthly cost of \$40. Thus your total monthly costs will amount to \$300 (\$20 + \$240 + \$40).

The Income Statement

Let's say that during your first month, you sell one hundred play packs. Not bad, you say to yourself, but did I make a *profit*? To find out, you prepare an income statement showing revenues, or sales, and expenses—the costs of doing business. You divide your expenses into two categories:

1. Cost of goods sold: the total cost of the *goods that you've sold*
2. Operating expenses: the costs of *operating your business* except for the costs of things that you've sold

Now you need to do a little subtracting:

- The positive difference between *sales* and *cost of goods sold* is your gross profit or gross margin.
- The positive difference between *gross profit* and *operating expenses* is your net income or profit, which is the proverbial "bottom line." (If this difference is *negative*, you took a *loss* instead of making a profit.)

Figure 4 "Income Statement for Stress-Buster Company" is your income statement for the first month. (Remember that we've made things simpler by handling everything in cash.)

Stress-Buster Company

Income Statement Month Ended September 30, 20X1

Sales (100 × \$10)		\$1,000
Less cost of goods sold (100 × \$6)		<u>600</u>
Gross profit (100 × \$4)		400
Less operating expenses		
Salaries	240	
Advertising	40	
Table rental	<u>20</u>	
	300	
Net income (profit)		<u><u>\$100</u></u>

Figure 73 Income Statement for Stress-Buster Company

Did You Make Any Money?

What does your income statement tell you? It has provided you with four pieces of valuable information:

- You sold 100 units at \$10 each, bringing in *revenues* or *sales* of \$1,000.
- Each unit that you sold cost you \$6—\$1 for the treasure chest plus 5 toys costing \$1 each. So your *cost of goods sold* is \$600 (100 units × \$6 per unit).
- Your *gross profit*—the amount left after subtracting cost of goods sold from sales—is \$400 (100 units × \$4 each).
- After subtracting *operating expenses* of \$300—the costs of doing business other than the cost of products sold—you generated a positive *net income* or *profit* of \$100.

What If You Want to Make More Money?

You're quite relieved to see that you made a profit during your first month, but you can't help but wonder what you'll have to do to make even more money next month. You

consider three possibilities:

1. Reduce your cost of goods sold (say, package four toys instead of five)
2. Reduce your operating costs (salaries, advertising, table rental)
3. Increase the quantity of units sold

In order to consider these possibilities fully, you need to generate new income statements for each option. And to do that, you'll have to play a few "what-if" games. Because possibility #1—packaging four toys instead of five—is the most appealing, you start there. Your cost of goods sold would go down from \$6 to \$5 per unit (4 toys at \$1 each + 1 plastic treasure chest at \$1). Figure 5 "Proposed Income Statement Number One for Stress-Buster Company" is your hypothetical income statement if you choose this option.

Stress-Buster Company		
Income Statement		
Month Ended September 30, 20X1		
[If cost of goods sold is \$5 per unit]		
Sales (100 × \$10)		\$1,000
Cost of goods sold (100 × \$5)		500
Gross profit (100 × \$5)		<u>500</u>
Less operating expenses		
Salaries	240	
Advertising	40	
Table rental	<u>20</u>	
	300	
Net income (profit)		<u><u>\$200</u></u>

Figure 74 Proposed Income Statement Number One for Stress-Buster Company

Possibility #1 seems to be a good idea. Under this scenario, your income doubles from \$100 to \$200 because your per-unit *gross profit* increases by \$1 (and you sold 100 stress packs). But there may be a catch: If you cut back on the number of toys, your customers might perceive your product as a lesser value for the money. In fact, you're reminded of a conversation that you once

had with a friend whose father, a restaurant owner, had cut back on the cost of the food he served by buying less expensive meat. In the short term, gross profit per meal went up, but customers eventually stopped coming back and the restaurant nearly went out of business.

Thus you decide to consider possibility #2—reducing your operating costs. In theory, it's a good idea, but in practice—at least in your case—it probably won't work. Why not? For one thing, you can't do without the table and you need your workers (because your grades haven't improved, you still don't have time to sit at the table yourself). Second, if you cut salaries from, say, \$6 to \$5 an hour, you may have a hard time finding people willing to



work for you. Finally, you could reduce advertising costs by running an ad every two weeks instead of every week, but this tactic would increase your income by only \$20 a month and could easily lead to a drop in sales.

Now you move on to possibility #3—increase sales. The appealing thing about this option is that it has no downside. If you could somehow increase the number of units sold from 100 Stress-Buster packs per month to 150, your income would go up, even if you stick with your original five-toy product. So you decide to crunch some numbers for possibility #3 and come up with the new “what-if” income statement in Figure 12.7 “Proposed Income Statement Number Two for Stress-Buster Company”.

Stress-Buster Company		
Income Statement		
Month Ended September 30, 20X1		
[If sales increase to 150 units]		
Sales (150 × \$10)		\$1,500
Cost of goods sold (150 × \$6)		900
Gross profit (150 × \$4)		<u>600</u>
Less operating expenses		
Salaries	240	
Advertising	40	
Table rental	<u>20</u>	
	300	
Net income (profit)		<u><u>\$300</u></u>

As you can see, this is an attractive possibility, even though you haven’t figured out how you’re going to increase sales (maybe you could put up some eye-popping posters and play cool music to attract people to your table. Or maybe your workers could attract buyers by demonstrating relaxation and stress-

Figure 75 Proposed Income Statement Number Two for Stress-Buster Company

reduction exercises).

Breakeven Analysis

Playing these what-if games has started you thinking: is there some way to figure out the level of sales you need to avoid *losing* money—to “break even”? This can be done using breakeven analysis. To break even (have no profit or loss), your *total sales revenue must exactly equal all your expenses (both variable and fixed)*. For a merchandiser, like a hypothetical one called The College Shop, this balance will occur when gross profit equals all other (fixed) costs. To determine the level of sales at which this will occur, you need to do the following:

1. Determine your total fixed costs, which are so called because the total cost doesn't change as the quantity of goods sold changes):
 - Fixed costs = \$240 salaries + \$40 advertising + \$20 table = \$300
2. Identify your variable costs. These are costs that vary, in total, as the quantity of goods sold changes but stay constant on a per-unit basis. State variable costs on a per-unit basis:
 - Variable cost per unit = \$6 (\$1 for the treasure chest and \$5 for the toys)
3. Determine your contribution margin per unit: selling price per unit – variable cost per unit:
 - Contribution margin per unit = \$10 selling price – \$6 variable cost per unit = \$4
4. Calculate your breakeven point in units: fixed costs ÷ contribution margin per unit:
 - Breakeven in units = \$300 fixed costs ÷ \$4 contribution margin per unit = 75 units

Your calculation means that if you sell 75 units, you'll end up with zero profit (or loss) and will exactly break even. To test your calculation, you can prepare a what-if income statement for 75 units in sales (which is your breakeven number of sales). The resulting statement is shown in Figure 7 "Proposed Income Statement Number Three for Stress-Buster Company".

What if you want to do better than just break even? What if you want to earn a profit of \$200 next month? How many Stress-Buster Pack units would you need to sell? You can find out by building on the results of your breakeven analysis. Note that each additional sale will bring in \$4 (contribution margin per unit). If you want to make a profit of \$200—which is \$200 *above your breakeven point*—you must sell an additional 50 units (\$200

Stress-Buster Company		
Income Statement		
Month Ended September 30, 20×1		
[At breakeven level of sales = 75 units]		
Sales (75 × \$10)		\$750
Less Cost of goods sold (75 × \$6)		<u>450</u>
Gross profit (75 × \$4)		300
Less Operating expenses		
Salaries	240	
Advertising	40	
Table rental	<u>20</u>	
	300	
Net income (profit)		<u><u>\$0</u></u>

Figure 76 Proposed Income Statement Number Three for Stress-Buster Company

desired profit divided by \$4 contribution margin per unit) above your breakeven point of 75 units. If you sell 125 units (75 breakeven units + the additional 50), you'll make a profit of \$200 a month.

As you can see, breakeven analysis is rather handy. It enables you to determine the level of sales that you must

reach to avoid losing money and the level of sales that you have to reach to earn a profit of \$200. Such information will help you plan for your business. For example, knowing you must sell 125 Stress-Buster Packs to earn a \$200 profit will help you decide how much time and money you need to devote to marketing your product.

The Balance Sheet

Your balance sheet reports the following information:

- Your assets: the resources from which it expects to gain some future benefit
- Your liabilities: the debts that it owes to outside individuals or organizations
- Your owner's equity: your investment in your business

Whereas your income statement tells you how much income you earned *over some period of time*, your balance sheet tells you what you have (and where it came from) *at a specific point in time*.

Most companies prepare financial statements on a twelve-month basis—that is, for a fiscal year which ends on December 31 or some other logical date, such as June 30 or September 30. Why do fiscal years vary? A company generally picks a fiscal-year end date that coincides with the end of its peak selling period; thus a crabmeat processor might end its fiscal year in October, when the crab supply has dwindled. Most companies also

produce financial statements on a quarterly or monthly basis. For Stress-Buster, you'll want to prepare a monthly balance sheet.

The Accounting Equation

The balance sheet is based on the accounting equation:

$$\text{assets} = \text{liabilities} + \text{owner's equity}$$

This important equation highlights the fact that a company's *assets* came from somewhere: either from loans (*liabilities*) or from investments made by the owners (*owner's equity*). This means that the asset section of the balance sheet on the one hand and the liability and owner's-equity section on the other must be equal, or *balance*. Thus the term *balance sheet*.

Let's prepare two balance sheets for your company: one for the first day you started and one for the end of your first month of business. We'll assume that when you started

Stress-Buster Company	
Balance Sheet As of September 1, 20×1	
Assets	
Cash	\$600
Liabilities and Owner's equity	
Liabilities	400
Owner's equity	200
Total Liabilities and Owner's equity	<u>\$600</u>

Figure 77 Balance Sheet Number One for Stress-Buster Company

Stress-Buster, you borrowed \$400 from your parents and put in \$200 of your own money. If you look at your first balance sheet in Figure 8 "Balance Sheet Number One for Stress-Buster Company" you'll see that your business has \$600 in cash (your *assets*): Of this total, you borrowed \$400 (your *liabilities*) and invested \$200 of your own money (your *owner's equity*). So far, so good: Your assets section *balances* with your liabilities and owner's equity section.

Now let's see how things have changed by the end of the month. Recall that Stress-

Buster earned \$100 (based on sales of 100 units) during the month of September and that you decided to leave these earnings in the business. This \$100 profit increases two items on your *balance sheet*: the *assets* of the company (its cash) and your investment in it (its *owner's equity*).

Stress-Buster Company	
Balance Sheet As of September 30, 20X1	
Assets	
Cash (original \$600 plus \$100 earned)	<u>\$700</u>
Liabilities and owner's equity	
Liabilities	400
Owner's equity (\$200 invested by owner plus \$100 profits retained)	<u>300</u>
Total liabilities and owner's equity	<u>\$700</u>

Figure 78 Balance Sheet Number Two for Stress-Buster Company

Figure 9 "Balance Sheet Number Two for Stress-Buster

Company" shows what your balance sheet will look like on September 30. Once again, it *balances*. You now have \$700 in cash: \$400 that you borrowed plus \$300 that you've invested in the business (your original \$200 investment plus the \$100 profit from the first month of operations, which you've kept in the business).

The Statement of Owner's Equity

Note that we used the *net income* figure from your *income statement* to update the owner's equity section of your end-of-month balance sheet. Often, companies prepare an additional financial statement, called the statement of owner's equity, which details changes in owner's equity for the reporting period. Figure 10 "Sample Statement of Owner's Equity for Stress-Buster Company" shows what this statement looks like.

Stress-Buster Company	
Statement of Owner's Equity As of September 30, 20X1	
Owner's equity, September 1, 20×1	\$200
+ Net income	<u>100</u>
Owner's equity, September 30, 20×1	<u>\$300</u>

Figure 79 Sample Statement of Owner's Equity for Stress-Buster Company

How Do Financial Statements Relate to One Another?

Stress-Buster Company		
Income Statement Month Ended September 30, 20X1		
Sales (100 × \$10)		\$1,000
Less cost of goods sold (100 × \$6)		<u>600</u>
Gross profit (100 × \$4)		400
Less operating expenses		
Salaries	240	
Advertising	40	
Table rental	<u>20</u>	
Net income (profit)	300	<u><u>\$100</u></u>

Net income for the month is also on the **Statement of Owner's Equity** as an addition to the beginning *Owner's equity* balance. This addition of \$100 increases the balance in *Owner's equity* from \$200 to \$300:



Stress-Buster Company	
Statement of Owner's Equity As of September 30, 20X1	
Owner's equity, September 1, 20×1	\$200
+ Net income	<u>100</u>
Owner's equity, September 30, 20×1	<u><u>\$300</u></u>

The ending *Owner's equity* balance of \$300 also appears on the **Balance Sheet** as *Owner's equity*:



Stress-Buster Company	
Balance Sheet As of September 30, 20X1	
Total assets	<u><u>\$700</u></u>
Liabilities and owner's equity	
Liabilities	400
Owner's equity	<u>300</u>
Total liabilities and owner's equity	<u><u>\$700</u></u>

Figure 80 How Financial Statements Relate to One Another

When you prepare your financial statements, you should complete them in a certain order:

1. Income statement
2. Statement of owner's equity
3. Balance sheet

Why must they be prepared in this order? Because financial statements are interrelated: Numbers generated on one financial statement appear on other financial statements. Figure 11 "How Financial Statements Relate to One Another" presents Stress-Buster's financial statements for the month ended September 30, 20X1. As you review these statements, note that in two cases, numbers from one statement appear in another statement:

If the interlinking numbers are carried forward correctly, and if assets and liabilities are listed correctly, then the balance sheet will *balance*: Total *assets* will equal the total of *liabilities* plus *owner's equity*.

Key Takeaways

- Accountants prepare four financial statements: *income statement*, *statement of owner's equity*, *balance sheet*, and *statement of cash flows* (which is discussed later in the chapter).
- The income statement shows a firm's revenues and expenses and whether it made a profit.
- The balance sheet shows a firm's assets, liabilities and owner's equity (the amount that its owners have invested in it).
- The balance sheet is based on the accounting equation:
 - $\text{assets} = \text{liabilities} + \text{owner's equity}$
 - This equation highlights the fact that a company's *assets* came from one of two sources: either from loans (its *liabilities*) or from investments made by owners (its *owner's equity*).
- The statement of owner's equity reports the changes in owner's equity that have occurred over a specified period of time.
- Financial statements should be completed in a certain order: *income statement*, *statement of owner's equity*, and *balance sheet*. These financial statements are interrelated because numbers generated on one financial statement appear on other financial statements.
- Breakeven analysis is a technique used to determine the level of sales needed to break even—to operate at a sales level at which you have neither profit nor loss.
- To break even, total sales revenue must exactly equal all your expenses (both variable and fixed costs).
- To calculate the breakeven point in units to be sold, you divide fixed costs by contribution margin per unit (selling price per unit minus variable cost per unit).
- This technique can also be used to determine the level of sales needed to obtain a specified profit.

Accrual Accounting

Learning Outcomes

1. Understand the difference between cash-basis and accrual accounting.
2. Understand the purpose of a statement of cash flows and describe its format.

In this section, we're going to take a step further into the world of accounting by examining the principles of *accrual accounting*. In our Stress-Buster illustration, we've assumed that all your transactions have been made in *cash*: You paid cash for your inputs (plastic treasure chests and toys) and for your other expenses, and your customers paid cash when they bought Stress-Buster packs. In the real world, of course, things are rarely that simple. In the following cases, timing plays a role in making and receiving payments:

- Customers don't always pay in cash; they often buy something and pay later. When this happens, the seller is owed money and has an account receivable (it will receive something later).
- Companies don't generally pay cash for materials and other expenses—they often pay later. If this is the case, the buyer has an account payable (it will pay something later).
- Many companies manufacture or buy goods and hold them in inventory before selling them. Under these circumstances, they don't report payment for the goods until they've been sold.
- Companies buy long-term assets (also called fixed assets), such as cars, buildings, and equipment, which they plan to use over an extended period (as a rule, for more than one year).

What Is Accrual Accounting?

In situations such as these, firms use accrual accounting: a system in which the accountant records a transaction *when it occurs*, without waiting until cash is paid out or received. Here are a few basic principles of accrual accounting:

- A sale is recognized on the income statement *when it takes place*, regardless of when cash is collected.
- An expense is recognized on the income statement *when it's incurred*, regardless of

when payment is made.

- An item manufactured for later sale or bought for resale becomes part of *inventory* and appears on the balance sheet *until it's actually sold*; at that point, it goes on the income statement under *cost of goods sold*.
- A *long-term asset* that will be used for several years—for example, a vehicle, machine, or building—appears on the balance sheet. Its cost is spread *over its useful life*—the number of years that it will be used. Its annual allocated cost appears on the income statement as a depreciation expense.

Going to School on a New Business Idea

As we saw in our Stress-Buster illustration, it's easier to make sense of accounting concepts when you see some real—or at least realistic—numbers being put to realistic use. So let's now assume that you successfully operated the Stress-Buster Company while you were in college. Now fast-forward to graduation, and rather than work for someone else, you've decided to set up a more ambitious business—some kind of retail outlet—close to the college. During your four years in school, you noticed that there was no store near campus that met the wide range of students' specific needs. Thus the mission of your proposed retail business: to provide products that satisfy the specific needs of college students.

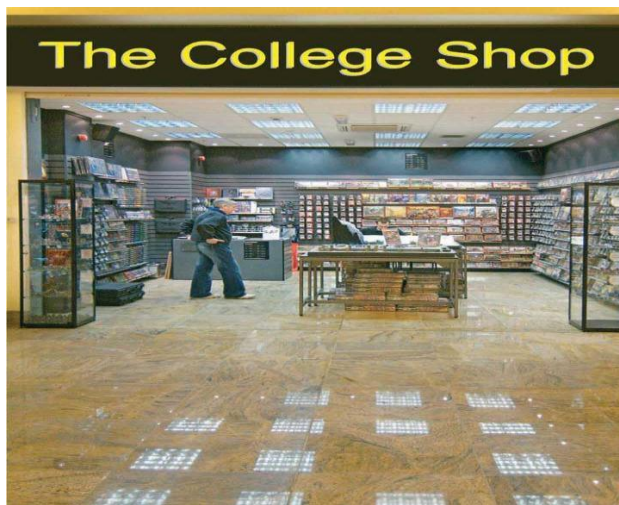


Figure 81 The College Shop

You've decided to call your store "The College Shop." Your product line will range from things needed to outfit a dorm room (linens, towels, small appliances, desks, rugs, dorm refrigerators) to things that are just plain fun and make student life more enjoyable (gift packages, posters, lava lamps, games, inflatable furniture, bean bag chairs, message boards, shower radios, backpacks). And of course you'll also sell the original Stress-Buster Fun Pack. You'll

advertise to students and parents through the college newspaper and your own Web site.

Accrual-Basis Financial Statements

At this point, we're going to repeat pretty much the same process that we went through with your first business. First, we'll prepare a *beginning balance sheet* that reflects your new company's assets, liabilities, and owner's equity on your first day of business—January 1, 20X6. Next, we'll prepare an *income statement* and a *statement of owner's equity*. Finally, we'll create a balance sheet that reflects the company's financial state at the end of your first year of business.

Although the process should now be familiar, the details of our new statements will be more complex—after all, your transactions will be more complicated: You're going to sell and buy stuff on credit, maintain an inventory of goods to be sold, retain assets for use over an extended period of time, borrow money and pay interest on it, and deal with a variety of expenses that you didn't have before (rent, insurance, etc.).

Beginning Balance Sheet

Your new beginning balance sheet contains the same items as the one that you created for Stress-Buster—cash, loans, and owner's equity. But because you've already performed a broader range of transactions before you opened for business, you'll need some new categories:

- You've bought furniture and equipment that you'll use over the next five years. You'll allocate the cost of these long-term assets by depreciating them. Because you estimate that this furniture and equipment will have a *useful life* of five years, you allocate one-fifth of the cost per year for five years.
- You've purchased an inventory of goods for later resale.
- You've taken out two types of loans: one that's *current* because it's payable in one year and one that's *long term* because it's due in five years.

Obviously, then, you need to prepare a more sophisticated balance sheet than the one you created for your first business. We call this new kind of balance sheet a classified balance sheet because it classifies assets and liabilities into separate categories.

Types of Assets

On a classified balance sheet, assets are listed in order of liquidity—how quickly they can be converted into cash. They’re also broken down into two categories:

1. Current assets—assets that you intend to convert into cash within a year
2. Long-term assets—assets that you intend to hold for more than a year

Your current assets will be cash and inventory, and your long-term assets will be furniture and equipment. We’ll take a closer look at the assets section of your beginning balance sheet, but it makes sense to analyze your liabilities first.

Types of Liabilities

Liabilities are grouped in much the same manner as assets:

1. Current liabilities—liabilities that you’ll pay off within one year
2. Long-term liabilities—liabilities that don’t become due for more than one year

Recall that your liabilities come from your two loans: one which is payable in a year and considered current, and one which is long term and due in five years. Now we’re ready to review your beginning balance sheet, which is shown in Figure 13 “Beginning Balance

The College Shop	
Balance Sheet	
As of January 1, 20×6	
Assets	
Current assets	
Cash	\$50,000
Inventory	75,000
Long-term assets	
Furniture, displays, and equipment	150,000
Total Assets	<u>\$275,000</u>
Liabilities and Owner’s equity	
Current liabilities	
Loan payable (due this year)	\$25,000
Long-term liabilities	
Loan payable (due in 5 years)	100,000
Owner’s equity	<u>150,000</u>
Total Liabilities and Owner’s equity	<u>\$275,000</u>

Sheet for The College Shop.” Once again, your balance sheet balances: Your total assets of \$275,000 equal your total liabilities plus owner’s equity of \$275,000.

Figure 82 Beginning Balance Sheet for The College Shop

Liabilities and Owner’s Equity

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Let's begin our analysis of your beginning balance sheet with the liabilities and owner's-equity sections. We're assuming that, thanks to a strong business plan, you've convinced a local bank to loan you a total of \$125,000—a short-term loan of \$25,000 and a long-term loan of \$100,000. Naturally, the bank charges you *interest* (which is the cost of borrowing money); your rate is 8 percent per year. In addition, you personally contributed \$150,000 to the business (thanks to a trust fund that paid off when you turned 21).

Assets

Now let's turn to the assets section of your beginning balance sheet. What do you have to show for your \$275,000 in liabilities and owner's equity? Of this amount, \$50,000 is in *cash*—that is, money deposited in the company's checking and other bank accounts. You used another \$75,000 to pay for *inventory* that you'll sell throughout the year. Finally, you spent \$150,000 on several *long-term assets*, including a sign for the store, furniture, store displays, and computer equipment. You expect to use these assets for five years, at which point you'll probably replace them.

Income Statement

Finally, let's look at your income statement, which is shown in Figure 14 "Income Statement for The College Shop, Year Ended December 31". Like your College Shop balance sheet, your College Shop income statement is more complex than the one you prepared for

The College Shop		
Income Statement		
Year Ended December 31, 20X6		
Sales		\$500,000
Less cost of goods sold		<u>275,000</u>
Gross profit		225,000
Less operating expenses		
Salaries and employee benefits	75,000	
Depreciation	30,000	
Rent and utilities	20,000	
Advertising	20,000	
Other (insurance, office expenses, miscellaneous)	<u>30,000</u>	
Total operating expenses	\$175,000	
Operating income (Income before interest and taxes)		50,000
Less interest expense (8% × loans of \$125,000)		<u>10,000</u>
Net income before income taxes		40,000
Less income taxes (25% × income before taxes)		<u>10,000</u>
Net income		<u><u>30,000</u></u>

Figure 83 Income Statement for The College Shop, Year Ended December 31

Stress-Buster, and the amounts are much larger. In addition, the statement covers a full

calendar year.

Note, by the way, that the income statement that we prepared for The College Shop is designed for a *merchandiser*—a company that makes a profit by selling goods. How can you tell? Businesses that sell services (such as accounting firms or airlines) rather than merchandise don't have lines labeled *cost of goods sold* on their statements.

The format of this income statement also highlights the most important financial fact in running a merchandising company: *you must sell goods at a profit (called gross profit) that is high enough to cover your operating costs, interest, and taxes*. Your income statement, for example, shows that The College Shop generated \$225,000 in *gross profit* through *sales* of goods. This amount is sufficient to cover your *operating expense*, interest, and taxes and still produce a *net income* of \$30,000.

A Few Additional Expenses

Note that The College Shop income statement also lists a few expenses that the Stress-Buster didn't incur:

- *Depreciation expense*. Recall that before opening for business, you purchased some long-term assets (store sign, displays, furniture, and equipment) for a total amount of \$150,000. In estimating that you would use these assets for five years (your estimate of their useful lives), you spread the cost of \$150,000 over five years. For each of these five years, then, your income statement will show \$30,000 in *depreciation expense* ($\$150,000 \div 5 \text{ years} = \$30,000$).
- *Interest expense*. When you borrowed money from the bank, you agreed to pay interest at an annual rate of 8 percent. Your *interest expense* of \$10,000 ($\$125,000 \times 0.08$) is a cost of financing your business and appears on your income statement after the subheading *operating income*.
- *Income taxes*. Your company has to pay income taxes at a rate of 25 percent of *net income before taxes*. This amount of \$10,000 ($\$40,000 \times 25\%$) appears on your income statement after the subheading *net income before income taxes*. It's subtracted from *income before income taxes* before you arrive at your "bottom line," or *net income*.

Statement of Owner's Equity

Our next step is to prepare a statement of owner's equity, which is shown in Figure 15 "Statement of Owner's Equity for The College Shop." Note that the *net income* of \$30,000 from the income statement was used to arrive at the year-end balance in owner's equity.

The College Shop	
Statement of Owner's Equity	
As of December 31, 20X6	
Owner's equity, January 1, 20X6	\$150,000
+ Net income	<u>30,000</u>
Owner's equity, December 31, 20X6	<u><u>\$180,000</u></u>

Figure 84 Statement of Owner's Equity for The College Shop

End-of-First-Year Balance Sheet

We'll conclude with your balance sheet for the end of your first year of operations, which is shown in Figure 16 "End-of-Year Balance Sheet for The College Shop". First, look at your assets. At year's end, you have a *cash balance* of \$70,000 and *inventory* of \$80,000. You also

The College Shop	
Balance Sheet	
As of December 31, 20X6	
Assets	
Current assets	
Cash	\$70,000
Accounts receivable	90,000
Inventory	80,000
Total Current assets	<u>240,000</u>
Long-term assets	
Furniture, displays, and equipment	150,000
Less: Accumulated depreciation	<u>(30,000)</u>
Total Long-term assets	<u>120,000</u>
Total Assets	<u><u>\$360,000</u></u>
Liabilities and Owner's equity	
Current liabilities	
Accounts payable	\$80,000
Long-term liabilities	
Loan payable (due in 4 years)	100,000
Owner's equity	
(150,000 + 30,000)	<u>180,000</u>
Total Liabilities and Owner's equity	<u><u>\$360,000</u></u>

Figure 85 End-of-Year Balance Sheet for The College Shop

have an *accounts receivable* of \$90,000 because many of your customers have bought goods on credit and will pay later. In addition, the balance sheet now shows two numbers for *long-term assets*: the original cost of these assets, \$150,000, and an *accumulated depreciation* amount of \$30,000, which reflects the amount that you've charged as

depreciation expense since the purchase of the assets. The carrying value of these long-term assets is now \$120,000 (\$150,000 - \$30,000), which is the difference between their original cost and the amount that they've been depreciated. Your *total assets* are thus \$360,000.

The total of your liabilities of \$180,000 plus owner's equity of \$180,000 also equals \$360,000. Your liabilities consist of a long-term loan of \$100,000 (which is now due in four years) and *accounts payable* of \$80,000 (money that you'll have to pay out later for purchases that you've made on credit). Your owner's equity (your investment in the business) totals \$180,000 (the \$150,000 you originally put in plus the \$30,000 in first-year earnings that you retained in the business).

Statement of Cash Flows

Owners, investors, and creditors can learn a lot from your balance sheet and your income statement. Indeed, each tells its own story. The balance sheet tells what assets your company has now and where they came from. The income statement reports earned income on an accrual basis (recognizing revenues when earned and expenses as incurred regardless of when cash is received or paid). But the key to surviving in business is generating the *cash* you need to keep it up and running. It's not unusual to hear reports about companies with cash problems. Sometimes they arise because the products in which the firm has invested aren't selling as well as it had forecast. Maybe the company tied up too much money in a plant that's too big for its operations. Maybe it sold products to customers who can't pay. Maybe management just overspent. Whatever the reason, cash problems will hamper any business. Owners and other interested parties need a financial statement that helps them understand a company's cash flow.

The statement of cash flows tells you where your cash came from and where it went. It furnishes information about three categories of *activities* that cause cash either to come in (*cash inflows*) or to go out (*cash outflows*):

1. Cash flows from operating activities come from the day-to-day operations of your main line of business.
2. Cash flows from investing activities result from buying or selling long-term assets.
3. Cash flows from financing activities result from obtaining or paying back funds used

to finance your business.

A cash flow statement for The College Shop would look like the one in Figure 17 "Statement of Cash Flows for The College Shop". You generated \$45,000 in cash from

The College Shop	
Cash Flow Statement	
As of December 31, 20×6	
Cash inflows from Operating activities	\$45,000
Cash outflows from Financing activities	<u>25,000</u>
Increase in cash during the year	<u>\$20,000</u>

Figure 86 Statement of Cash Flows for The College Shop

your company's operations (a cash inflow) and used \$25,000 of this amount to pay off your short-term loan (a cash outflow). The net result was an increase in cash of \$20,000. This \$20,000 increase in cash agrees with the change in your cash during the year as it's reported in your balance sheets: You had an

end-of-the-year cash balance of \$70,000 and a beginning-of-the-year balance of \$50,000 ($\$70,000 - \$50,000 = \$20,000$). Because you didn't buy or sell any *long-term assets* during the year, your cash flow statement shows no cash flows from investing activities.

Key Takeaways

- There are two different methods for reporting financial transactions:
 - Companies using *cash-basis accounting* recognize revenue as earned only when cash is received and recognize expenses as incurred only when cash is paid out.
 - Companies using accrual accounting recognize revenues when they're earned (regardless of when the cash is received) and expenses when they're incurred (regardless of when the cash is paid out).
- An item manufactured for later sale or bought for resale appears on the balance sheet as an asset called inventory. When it's sold, it goes on the income statement as an expense under the category *cost of goods sold*.

- The difference between *sales* and *cost of goods* sold is called gross profit.
- A merchandising company's gross profit must be high enough to cover its operating costs, interest, and taxes.
- An asset that will be used for several years (say, a truck) appears on the balance sheet as a long-term asset. Its cost is allocated over its *useful life* and appears on the income statement as a depreciation expense.
- A classified balance sheet separates assets and liabilities into two categories—*current* and *long-term*:
 - Current assets include those that you intend to convert into cash within a year; long-term assets include those that you plan to hold for more than a year.
 - Current liabilities include those that you'll pay off within a year; long-term liabilities include those that do not become due for more than a year.
- The statement of cash flows shows how much cash the business has coming in and going out.
- The *statement of cash flows* furnishes information about three categories of activities that cause cash either to come in or to go out: operating activities, investing activities, and financing activities.

Financial Statement Analysis

Learning Outcome

1. Evaluate a company's performance using financial statements and ratio analysis.

Now that you know how financial statements are prepared, let's see how they're used to help owners, managers, investors, and creditors assess a firm's performance and financial strength. You can glean a wealth of information from financial statements, but first you need to learn a few basic principles for "unlocking" it.

The Comparative Income Statement

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Let's fast-forward again and assume that your business—The College Shop—has just completed its second year of operations.

After creating your second-year income statement, you decide to compare the numbers from this statement with those from your first statement. So you prepare the

The College Shop		
Comparative Income Statement		
Years Ended December 31, 20×7 and 20×6		
	<u>12/31/20×7</u>	<u>12/31/20×6</u>
Sales	\$600,000	\$500,000
Less Cost of goods sold	<u>387,000</u>	<u>275,000</u>
Gross profit	213,000	225,000
Less Operating expenses	<u>180,000</u>	<u>175,000</u>
Operating income	33,000	50,000
Less Interest	10,000	10,000
Less Income taxes	<u>5,000</u>	<u>10,000</u>
Net income	<u>\$18,000</u>	<u>\$30,000</u>

Figure 87 Comparative Income Statement for The College Shop

comparative income statement in Figure 18 "Comparative Income Statement for The College Shop", which shows income figures for year 2 and year 1 (accountants generally put numbers for the most recent year in the inside column).

Vertical Percentage Analysis

What does this statement tell us about your second year in business? Some things look good and some don't. Your sales went up from \$500,000 to \$600,000 (a 20 percent increase—not bad). But your profit was down—from \$30,000 to \$18,000 (a bad sign). As you stare at the statement, you're asking yourself the question: Why did my profit go down even though my sales went up? Does this result make sense? Is there some way of comparing two income statements that will give me a more helpful view of my company's financial health? One way is called vertical percentage analysis. It's useful because it reveals the relationship of each item on the income statement to a specified base—generally sales—by expressing each item as a percentage of that base. Figure 19 "Comparative Income Statement Using Vertical Percentage Analysis" shows what comparative income statements look like when you use vertical percentage analysis showing each item as a percentage of sales. Let's see if this helps clarify things. What do you think accounted for the company's drop in income even though The College Shop sales went up?

The College Shop

Comparative Income Statement
 Years Ended December 31, 20×7 and 20×6
 [Using vertical percentage analysis
 showing each item as a % of sales]

	<u>12/31/20×7</u>		<u>12/31/20×6</u>	
	Amount	Percent	Amount	Percent
Sales	\$600,000	100	\$500,000	100
Less Cost of goods sold	<u>387,000</u>	<u>64</u>	<u>275,000</u>	<u>55</u>
Gross profit	213,000	36	225,000	45
Less Operating expenses	<u>180,000</u>	<u>30</u>	<u>175,000</u>	<u>35</u>
Operating income	33,000	6	50,000	10
Less Interest	10,000	2	10,000	2
Less Income taxes	<u>5,000</u>	<u>1</u>	<u>10,000</u>	<u>2</u>
Net income	<u>\$18,000</u>	<u>3%</u>	<u>\$30,000</u>	<u>6%</u>

Figure 88 Comparative Income Statement Using Vertical Percentage Analysis

The percentages help you to analyze changes in the income statement items over time, but it might be easier if you think of the percentages as pennies. In year 1, for example, for every \$1.00 of sales, \$0.55 went to pay for

the goods that you sold, leaving \$0.45 to cover your other costs and leave you a profit. Operating expenses (salaries, rent, advertising, and so forth) used up \$0.35 of every \$1.00 of sales, while interest and taxes took up \$0.02 each. After you covered all your costs, you had \$0.06 profit for every \$1.00 of sales.

Asking the Right Questions

Now, compare these figures to those for year 2. Where is the major discrepancy? It's in *Cost of goods sold*. Instead of using \$0.55 of every \$1.00 of sales to buy the goods you sold, you used \$0.64. As a result, you had \$0.09 less (\$0.64 – \$0.55) to cover other costs. This is the major reason why you weren't as profitable in year 2 as you were in year 1: your *Gross profit as a percentage of sales* was lower in year 2 than it was in year 1. Though this information doesn't give you all the answers you'd like to have, it does, however, raise some interesting questions. Why was there a change in the relationship between *Sales* and *Cost of goods sold*? Did you have to pay more to buy goods for resale and, if so, were you unable to increase your selling price to cover the additional cost? Did you have to reduce prices to move goods that weren't selling well? (If your costs stay the same but your selling price goes down, you make less on each item sold.) Answers to these questions require further analysis, but at least you know what the useful questions are.

Ratio Analysis



Vertical percentage analysis helps you analyze relationships between items on your income statement. But how do you compare your financial results with those of other companies in your industry or with the industry overall? And what about your balance sheet? Are there relationships on this statement that also warrant investigation? Should you further examine any relationships between items on your income statement and items on your balance sheet? These issues can be explored by using ratio analysis, a technique for evaluating a company's financial performance.

First, remember that a *ratio* is just one number divided by another, with the result expressing the relationship between the two numbers. Let's say, for example, that you want to know the relationship between the cost of going to a movie and the cost of renting a DVD movie. You could make the following calculation:

- Cost of going to a movie/Cost of renting a DVD = $\$8/\$4 = 2$ (or 2 to 1)
- Going to a movie costs two times as much as renting a DVD.

Ratio analysis is also used to assess a company's performance over time and to compare one company to similar companies or to the overall industry in which it operates. You don't learn much from just one ratio, or even a number of ratios covering the same period. Rather, the value in ratio analysis lies in looking at the *trend* of ratios over time and in comparing the ratios for several time periods with those of competitors and the industry as a whole. There are a number of different ways to categorize financial ratios. Here's just one set of categories:

- Profit margin ratios tell you how much of each sales dollar is left after certain costs are covered.
- Management efficiency ratios tell you how efficiently your assets are being managed.
- Management effectiveness ratios tell you how effective management is at running the business and measure overall company performance.
- Financial condition ratios help you assess a firm's financial strength.

Using each of these categories, we can find dozens of different ratios, but we'll focus on a few examples.

Profit Margin Ratios

We've already determined the two most common profit margin ratios—*gross profit margin* and *net profit margin*—when we used vertical percentage analysis to determine the relationship to *Sales* of each item on The College Shop's income statement. We were examining gross profit when we found that *Gross profit* for year 1 was 45 percent of *Sales* and that, in year 2, it had declined to 36 percent. We can express the same relationships as ratios:

$$\text{Gross profit margin} = \text{Gross profit} / \text{Sales}$$

$$\text{Year 1: } \$225,000 / \$500,000 = 45\%$$

$$\text{Year 2: } \$213,000 / \$600,000 = 36\% \text{ (rounded)}$$

We can see that gross profit margin declined (a situation that, as we learned earlier, probably isn't good). But how can you tell whether your gross profit margin for year 2 is appropriate for your company? For one thing, we can use it to compare The College Shop's results to those of its industry. When we make this comparison, we find that the specialized retail industry (in which your company operates) reports an average gross profit margin of 41 percent. For year 1, therefore, we had a higher ratio than the industry; in year 2, though we had a lower ratio, we were still in the proverbial ballpark. It's worthwhile to track gross profit margin, whether for your company or for companies that you might invest in or lend money to. In particular, you'll gain some insight into *changes* that might be occurring in a business. For instance, what if you discover that a firm's gross profit margin has declined? Is it because it's costing more for the company to buy or make its products, or is it because its competition is forcing it to lower its prices?

Net Profit Margin

Net profit is the money that a company earns *after paying all its expenses*, including the costs of buying or making its products, running its operations, and paying interest and taxes. Look again at Figure 19 "Comparative Income Statement Using Vertical Percentage Analysis". Using vertical percentage analysis, we found that for The College Shop, net profit as a percentage of sales was 6 percent in year 1 but declined to 3 percent in year 2. Expressed as ratios, these relationships would look like this:

$$\text{Net profit margin} = \text{Net profit} / \text{Sales}$$

$$\text{Year 1: } \$30,000 / \$500,000 = 6\%$$

$$\text{Year 2: } \$18,000 / \$600,000 = 3\% \text{ (rounded)}$$

You realize that a declining net profit margin isn't good, but you wonder how you compare with your industry. A little research informs you that average net profit margin in the industry is 7 percent. You performed nearly as well as the industry in year 1 but fell further from your target in year 2. What does this information tell you? That a goal for year 3 should be trying to increase your net profit margin.

Management Efficiency Ratios

These ratios reveal the way in which assets (shown on the balance sheet) are being used to generate income (shown on the income statement). To compute this group of ratios, therefore, you must look at both statements. In Figure 18 "Comparative Income Statement for The College Shop", we produced a

The College Shop		
Comparative Balance Sheet		
As of December 31, 20×7 and 20×6		
	<u>12/31/20×7</u>	<u>12/31/20×6</u>
Assets		
Current assets		
Cash	\$76,000	\$70,000
Accounts receivable	92,000	90,000
Inventory	110,000	80,000
Total Current assets	<u>278,000</u>	<u>240,000</u>
Long-term assets		
Furniture, equipment, net of depreciation	<u>90,000</u>	<u>120,000</u>
Total Assets	<u>368,000</u>	<u>\$360,000</u>
Liabilities and Owner's equity		
Current liabilities		
Accounts payable	\$70,000	80,000
Long-term liabilities		
Loan	<u>100,000</u>	<u>100,000</u>
Total Liabilities	<u>170,000</u>	<u>180,000</u>
Owner's equity	<u>198,000</u>	<u>180,000</u>
Total Liabilities and Owner's equity	<u>\$368,000</u>	<u>\$360,000</u>

Figure 89 Comparative Balance Sheet for The College Shop

comparative income statement for The College Shop's first two years. Figure 20 "Comparative Balance Sheet for The College Shop" is a comparative balance sheet for the same period.

As you can see from Figure 20 "Comparative Balance Sheet for The College Shop", running even a small business entails a substantial investment in assets. Even if you rent

space, for example, you must still buy furniture and equipment. To have products on hand to sell, you need to tie up money in inventory. And once you've sold them, you may have money tied up in accounts receivable while you're waiting for customers to pay you. Thus, investing in assets is a normal part of doing business. Managing your assets efficiently is a basic requirement of business success. Let's look at a representative management efficiency ratio. The inventory turnover ratio measures a firm's efficiency in selling its inventory.

You don't make money from unsold inventory. You make money when you sell inventory, and the faster you sell it, the more money you make. To determine how fast your inventory is "turning," you need to examine the relationship between sales and inventory.³⁴⁶ Let's see how well The College Shop is doing in moving its inventory:

$$\text{Inventory turnover} = \text{Sales/Inventory}$$

$$\text{Year 1: } \$500,000/\$80,000 = 6.25 \text{ times}$$

$$\text{Year 2: } \$600,000/\$110,000 = 5.45 \text{ times}$$

For year 1, The College Shop converted its inventory into sales 6.25 times: on average, your entire inventory was sold and replaced 6.25 times during the year. For year 2, however, inventory was converted into sales only 5.45 times. The industry did better, averaging turnover of 6.58 times. Before we discuss possible reasons for the drop in The College Shop's inventory turnover ratio, let's look at an alternative way of describing this ratio. Simply convert this ratio into the average number of days that you held an item in inventory. In other words, divide 365 days by your turnover ratio:

$$\text{Year 1: } 365/6.25 = 58 \text{ days}$$

$$\text{Year 2: } 365/5.45 = 67 \text{ days}$$

$$\text{Industry: } 365/6.58 = 55 \text{ days}$$

The College Shop was doing fine in year 1 (relative to the industry), but something happened in year 2 to break your stride. Holding onto inventory for an extra 9 days (67 days for year 2 minus 58 days for year 1) is costly. What happened? Perhaps inventory

levels were too high because you overstocked. It's good to have products available for customers, but stocking too much inventory is costly. Maybe some of your inventory takes a long time to sell because it's not as appealing to customers as you thought. If this is the case, you may have a problem for the next year because you'll have to cut prices (and reduce profitability) in order to sell the same slow-moving inventory.

Optimal inventory turnover varies by industry and even by company. A supermarket, for example, will have a high inventory turnover because many of its products are perishable and because it makes money by selling a high volume of goods (making only pennies on each sale). A company that builds expensive sailboats, by contrast, will have a low inventory turnover: it sells few boats but makes a hefty profit on each one. Some companies, such as Dell Computer, are known for keeping extremely low inventory levels. Because computers are made to order, Dell maintains only minimal inventory and so enjoys a very high ratio of sales to inventory.

Management Effectiveness Ratios

"It takes money to make money," goes the old saying, and it's true. Even the smallest business uses money to grow. Management effectiveness ratios address the question: how well is a company performing with the money that owners and others have invested in it?

These ratios are widely regarded as the best measure of corporate performance. You can give a firm high marks for posting good profit margins or for turning over its inventory quickly, but the final grade depends on how much profit it generates with the money invested by owners and creditors. Or, to put it another way, that grade depends on the answer to the question: is the company making a sufficiently high return on its assets?

Like management efficiency ratios, management effectiveness ratios examine the relationship between items on the income statement and items on the balance sheet. From the income statement you always need to know the "bottom line"—net profit. The information that you need from the balance sheet varies according to the ratio that you're trying to calculate, but it's always *some measure of the amount of capital used in the business*. Common measures of capital investment include total equity, total assets, or a combination of equity and long-term debt. Let's see whether The College Shop made the

grade. Did it generate a reasonable profit on the assets invested in the company?

$$\text{Return on assets} = \text{Net Profit} / \text{Total assets}$$

$$\text{Year 1: } \$30,000 / \$360,000 = 8.3\%$$

$$\text{Year 2: } \$18,000 / \$368,000 = 4.9\%$$

Because the industry average return on assets is 7.9 percent, The College Shop gets an “A” for its first year’s performance. It slipped in the second year but is probably still in the “B” range.

Financial Condition Ratios

Financial condition ratios measure the financial strength of a company. They assess its ability to pay its current bills; and to determine whether its debt load is reasonable, they examine the proportion of its debt to its equity.

Current Ratio

Let’s look first at a company’s ability to meet current obligations. The ratio that evaluates this ability is called the current ratio, which examines the relationship between a company’s current assets and its current liabilities. The balance of The College Shop’s current assets and current liabilities appears on the comparative balance sheet in Figure 20 "Comparative Balance Sheet for The College Shop". By calculating its current ratio, we’ll see whether the business is likely to have trouble paying its current liabilities.

$$\text{Current ratio} = \text{Current assets} / \text{Current liabilities}$$

$$\text{Year 1: } \$240,000 / \$80,000 = 3 \text{ to } 1$$

$$\text{Year 2: } \$278,000 / \$70,000 = 4 \text{ to } 1$$

The College Shop’s current ratio indicates that, in year 1, the company had \$3.00 in current assets for every \$1.00 of current liabilities. In the second year, the company had \$4.00 of current assets for every \$1.00 of current liabilities. The average current ratio for the industry is 2.42. The good news is that The College Shop should have no trouble meeting its current obligations. The bad news is that, ironically, its current ratio might be

too high: companies should have enough liquid assets on hand to meet current obligations, but not too many. Holding excess cash can be costly when there are alternative uses for it, such as paying down loans or buying assets that can generate revenue. Perhaps The College Shop should reduce its current assets by using some of its cash to pay a portion of its debt.

Debt-to-Equity Ratio

Now let's look at the way The College Shop is financed. The debt-to-equity ratio (also called debt ratio) examines the riskiness of a company's capital structure—the relationship between funds acquired from creditors (*debt*) and funds invested by owners (*equity*):

$$\text{Total debt to equity} = \text{Total liabilities} / \text{Total equity}$$

$$\text{Year 1: } \$180,000 / \$180,000 = 1$$

$$\text{Year 2: } \$170,000 / \$198,000 = 0.86$$

In year 1, the ratio of 1 indicates that The College Shop has an equal amount of equity and debt (for every \$1.00 of equity, it has \$1.00 of debt). But this proportion changes in year 2, when the company has more equity than debt: for every \$1.00 of equity, it now has \$0.86 in debt. How does this ratio compare to that of the industry? The College Shop, it seems, is heavy on the debt side: the industry average of 0.49 indicates that, on average, companies in the industry have only \$0.49 of debt for every \$1.00 of equity. Its high debt-to-equity ratio might make it hard for The College Shop to borrow more money in the future.

How much difference can this problem make to a business when it needs funding? Consider the following example. Say that you have two friends, both of whom want to borrow money from you. You've decided to loan money to only one of them. Both are equally responsible, but you happen to know that one has only \$100 in the bank and owes \$1,000. The other also has \$100 in the bank but owes only \$50. To which one would you lend money? The first has a debt-to-equity ratio of 10 (\$1,000 debt to \$100 equity) and the second a ratio of 0.50 (\$50 debt to \$100 equity). You—like a banker—will probably lend money to the friend with the better debt-to-equity ratio, even though the other one needs the money more.

It's possible, however, for a company to make its interest payments comfortably even though it has a high debt-to-equity ratio. Thus, it's helpful to compute the interest coverage ratio, which measures the number of times that a firm's operating income can cover its interest expense. We compute this ratio by examining the relationship between interest expense and operating income. A high-interest coverage ratio indicates that a company can easily make its interest payments; a low ratio suggests trouble. Here are the interest coverage ratios for The College Shop:

$$\text{Interest coverage} = \text{Operating income} / \text{Interest expense}$$

$$\text{Year 1: } \$50,000 / \$10,000 = 5 \text{ times}$$

$$\text{Year 2: } \$33,000 / \$10,000 = 3.3 \text{ times}$$

As the company's income went down, so did its interest coverage (which isn't good). But the real problem surfaces when you compare the firm's interest coverage with that of its industry, which is much higher—14.5. This figure means that companies in the industry have, on average, \$14.50 in operating income to cover each \$1.00 of interest that it must pay. Unfortunately, The College Shop has only \$3.30.

Again, consider an example on a more personal level. Let's say that following graduation, you have a regular interest payment due on some student loans. If you get a fairly low-paying job and your income is only 3 times the amount of your interest payment, you'll have trouble making your payments. If, on the other hand, you land a great job and your income is 15 times the amount of your interest payments, you can cover them much more comfortably.

What Have the Ratios Told Us?

So, what have we learned about the performance of The College Shop? What do we foresee for the company in the future? To answer this question, let's identify some of the basic things that every businessperson needs to do in order to achieve success:

- Make a good profit on each item you sell.
- Move inventory: the faster you sell inventory, the more money you make.
- Provide yourself and others with a good return on investment: make investing in

your business worthwhile.

- Watch your cash: if you run out of cash and can't pay your bills, you're out of business.

The ratios that we've computed in this section allow us to evaluate The College Shop on each of these dimensions, and here's what we found:

- Profit margin ratios (gross profit margin and net profit margin) indicate that the company makes a reasonable profit on its sales, though profitability is declining.
- One management efficiency ratio (inventory turnover) suggests that inventory is moving quickly, though the rate of turnover is slowing.
- One management effectiveness ratio (return on assets) tells us that the company generated an excellent return on its assets in its first year and a good return in its second year. But again, the trend is downward.
- Financial condition ratios (current ratio, total debt-to-equity, and interest coverage) paint a picture of a company heading for financial trouble. While meeting current bills is not presently a problem, the company has too much debt and isn't earning enough money to make its interest payments comfortably. Moreover, repayment of a big loan in a few years will put a cash strain on the company.

What, then, does the future hold for The College Shop? It depends. If the company returns to year-1 levels of gross margin (when it made \$0.45 on each \$1.00 of sales), and if it can increase its sales volume, it might generate enough cash to reduce its long-term debt. But if the second-year decline in profitability continues, it will run into financial difficulty in the next few years. It could even be forced out of business when the bank demands payment on its long-term loan.

Key Takeaways

- Two common techniques for evaluating a company's financial performance are vertical percentage analysis and ratio analysis.
- Vertical percentage analysis reveals the relationship of each item on the income statement to a specified base—generally sales—by expressing each item as a percentage of that base.
- The percentages help you to analyze changes in the income statement items over time.
- Ratios show the relationship of one number to another number—for example, gross profit to sales or net profit to total assets.
- Ratio analysis is used to assess a company's performance and financial condition over time and to compare one company to similar companies or to an overall industry.
- Ratios can be divided into four categories: profit margin ratios, management efficiency ratios, management effectiveness ratios, and debt-to-equity ratios.
- Profit margin ratios show how much of each sales dollar is left after certain costs are covered.
- Two common profitability ratios are the *gross profit margin* (which shows how much of each sales dollar remains after paying for the goods sold) and *net profit margin* (which shows how much of each sales dollar remains after all costs are covered).
- Management efficiency ratios tell you how efficiently your assets are being managed.
- One of the ratios in this category—inventory turnover—measures a firm's efficiency in selling its inventory by looking at the relationship between sales and inventory.

- **Management effectiveness ratios** tell you how effective management is at running the business and measure overall company performance by comparing net profit to some measure of the amount of capital used in the business.
 - The **return on assets ratio**, for instance, compares net profit to total assets to determine whether the company generated a reasonable profit on the assets invested in it.
 - **Financial condition ratios** are used to assess a firm's financial strength.
 - The **current ratio** (which compares **current assets** to **current liabilities**) provides a measure of a company's ability to meet current liabilities.
 - The **debt-to-equity ratio** examines the riskiness of a company's **capital structure** by looking at the amount of debt that it has relative to total equity.
 - Finally, the **interest coverage ratio** (which measures the number of times a firm's operating income can cover its interest expense) assesses a company's ability to make interest payments on outstanding debt.

Chapter 12 Review Questions

Multiple Choice:

- This financial report shows sales minus expenses for profits or losses.
 1. income statement
 2. balance sheet
 3. statement of cash flows
 4. statement of owner's equity
- _____ accounting records a transaction when it occurs.
 1. Accrual
 2. Financial
 3. Management
 4. Cost
- You would find *Inventory* listed on the _____.
 1. income statement
 2. balance sheet
 3. statement of cash flows
 4. statement of owner's equity
- This ratio shows an overall percentage profits earned.
 1. Profit margin
 2. Return on Assets
 3. Current
 4. Debt-to-Equity
- This ratio uses current assets divided by current liabilities.
 1. Profit margin
 2. Return on Assets
 3. Current
 4. Debt-to-Equity

Short Answer:

1. What are the four (4) main financial statements prepared by accountants?
2. Explain the four categories of ratios.
3. Describe how ratio analysis is used and the value of it.

Chapter 13 Managing Financial Resources

The Functions of Money

Learning Outcome

1. Identify the functions of money and describe the three government measures of the money supply.

Finance is about money. So our first question is, what is money? If you happen to have one on you, take a look at a \$5 bill. What you'll see is a piece of paper with a picture of Abraham Lincoln on one side and the Lincoln Memorial on the other. Though this piece of paper—indeed, money itself—has no intrinsic value, it's certainly in demand. Why?

Because money serves three basic functions. Money is the following:

1. A medium of exchange
2. A measure of value
3. A store of value

To get a better idea of the role of money in a modern economy, let's imagine a system in which there is no money. In this system, goods and services are *bartered*—traded directly for one another. Now, if you're living and trading under such a system, for each barter exchange that you make, you'll have to have something that another trader wants. For example, say you're a farmer who needs help clearing his fields. Because you have plenty of food, you might enter into a barter transaction with a laborer who has time to clear fields but not enough food: he'll clear your fields in return for three square meals a day. This system will work as long as two people have exchangeable assets, but needless to say, it can be inefficient. If we identify the functions of money, we'll see how it improves the exchange for all the parties in our hypothetical set of transactions.

Medium of Exchange

Money serves as a medium of exchange because people will accept it in exchange for goods and services. Because people can use money to buy the goods and services that

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they want, everyone's willing to trade something for money. The laborer will take money for clearing your fields because he can use it to buy food. You'll take money as payment for his food because you can use it not only to pay him but also to buy something else you need (perhaps seeds for planting crops).

For money to be used in this way, it must possess a few crucial properties:

1. It must be *divisible*—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 rip 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 must be strong enough to resist tearing and the print can't wash off if it winds up in the washing machine.
4. It must be *difficult to counterfeit*; it won't have much value if people can make their own.

Measure of Value

Money simplifies exchanges because it serves as a measure of value. We state the price of a good or service in monetary units so that potential exchange partners know exactly how much value we want in return for it. This practice is a lot better than bartering because it's much more precise than an ad hoc agreement that a day's work in the field has the same value as three meals.

Store of Value

Money serves as a store of value. Because people are confident that money keeps its value over time, they're willing to save it for future exchanges. Under a bartering arrangement, the laborer earned three meals a day in exchange for his work. But what if, on a given day, he skipped a meal? Could he "save" that meal for another day? Maybe, but if he were paid in money, he could decide whether to spend it on food each day or save some of it for the future. If he wanted to collect on his "unpaid" meal two or three days later, the farmer might not be able to "pay" it; unlike money, food could go bad.

The Money Supply

Now that we know what money does, let's tackle another question: How much money is there? How would you go about "counting" all the money held by individuals, businesses, and government agencies in this country? You could start by counting the money that's held to pay for things on a daily basis. This category includes *cash* (paper bills and coins) and funds held in demand deposits—checking accounts, which pay given sums to "payees" when they demand them.

Then, you might count the money that's being "saved" for future use. This category includes *interest-bearing accounts*, *time deposits* (such as *certificates of deposit*, which pay interest after a designated period of time), and money market mutual funds, which pay interest to investors who pool funds to make short-term loans to businesses and the government.

M-1 and M-2

Counting all this money would be a daunting task (in fact, it would be impossible). Fortunately, there's an easier way—namely, by examining two measures that the government compiles for the purpose of tracking the money supply: M-1 and M-2.

- The narrowest measure, M-1, includes the most *liquid* forms of money—the forms, such as cash and checking-accounts funds, that are spent immediately.
- M-2 includes everything in M-1 plus *near-cash items* invested for the short term—savings accounts, time deposits below \$100,000, and money market mutual funds.

So what's the bottom line? How much money *is* out there? To find the answer, you can go to the Federal Reserve Board Web site. The Federal Reserve reports that in September 2011, M-1 was about \$2.1 trillion and M-2 was \$9.6 trillion.³⁴⁷ Figure 1 "The U.S. Money Supply, 1980–2010" shows the increase in the two money-supply measures since 1980.

If you're thinking that these numbers are too big to make much sense, you're not alone. One way to bring them into perspective is to figure out how much money *you'd* get if all the money in the United States were redistributed equally. According to the U.S. Census Population Clock,³⁴⁸ there are more than three hundred million people in the United States. Your share of M-1, therefore, would be about \$6,700 and your share of M-2 would be

about \$31,000.

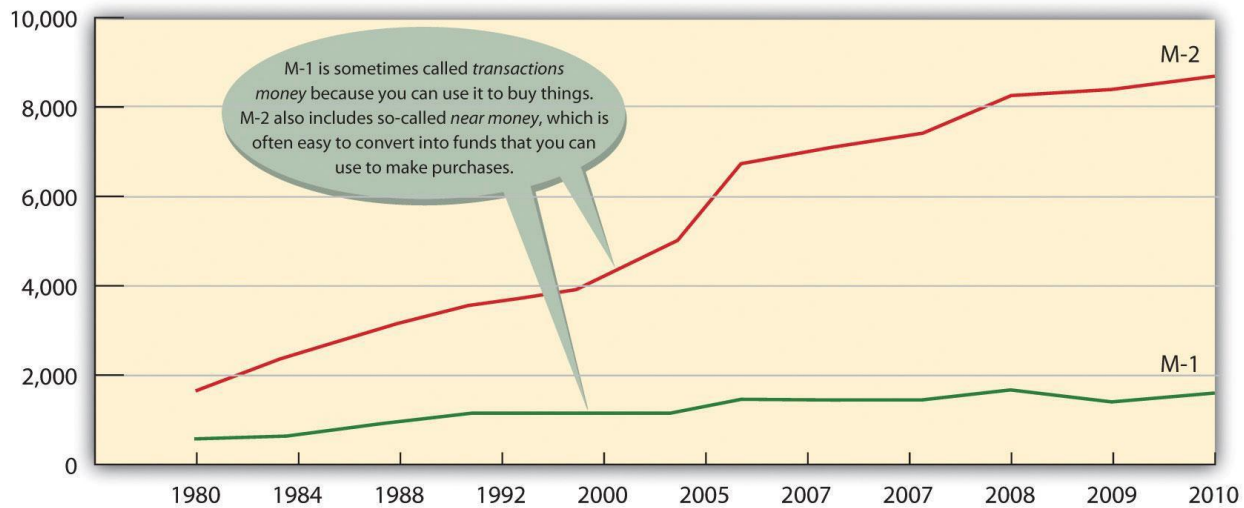


Figure 90 The U.S. Money Supply, 1980–2010

What, Exactly, Is “Plastic Money”?

Are credit cards a form of money? If not, why do we call them plastic money? Actually, when you buy something with a credit card, you’re not spending money. The principle of the credit card is buy-now-pay-later. In other words, when you use plastic, you’re taking out a loan that you intend to pay off when you get your bill. And the loan itself is not money. Why not? Basically because the credit card company can’t use the asset to buy anything. The loan is merely a promise of repayment. The asset doesn’t become money until the bill is paid (with interest). That’s why credit cards aren’t included in the calculation of M-1 and M-2.

Key Takeaways

- Money serves three basic functions:
 1. *Medium of exchange*: because you can use it to buy the goods and services you want, everyone’s willing to trade things for money.
 2. *Measure of value*: it simplifies the exchange process because it’s a means of indicating how much something costs.
 3. *Store of value*: people are willing to hold onto it because they’re confident that it will keep its value over time.

- 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

Learning Outcomes

1. Distinguish among different types of financial institutions.
2. Discuss the services that financial institutions provide and explain their role in expanding the money supply.

For financial transactions to happen, money must change hands. How do such exchanges occur? At any given point in time, some individuals, businesses, and government agencies have more money than they need for current activities; some have less than they need. Thus, we need a mechanism to match up savers (those with surplus money that they're willing to lend out) with borrowers (those with deficits who want to borrow money). We could just let borrowers search out savers and negotiate loans, but the system would be both inefficient and risky. Even if you had a few extra dollars, would you lend money to a total stranger? If you needed money, would you want to walk around town looking for someone with a little to spare?

Depository and Non-depository Institutions

Now you know why we have financial institutions: they act as intermediaries between savers and borrowers and they direct the flow of funds between them. With funds deposited by savers in checking, savings, and money market accounts, they make loans to individual and commercial borrowers. In the next section, we'll discuss the most common types of depository institutions (banks that accept deposits), including *commercial banks*, *savings banks*, and *credit unions*. We'll also discuss several non-depository institutions (which provide financial services but don't accept deposits), including finance companies, insurance companies, brokerage firms, and pension funds.

Commercial Banks

Commercial banks are the most common financial institutions in the United States, with total financial assets of about \$13.5 trillion (85 percent of the total assets of the banking institutions).³⁴⁹ They generate profit not only by charging borrowers higher interest rates than they pay to savers but also by providing such services as check processing, trust- and retirement-account management, and electronic banking. The country's 7,000 commercial banks range in size from very large (Bank of America, J.P. Morgan Chase) to very small (local community banks). Because of mergers and financial problems, the number of banks has declined significantly in recent years, but, by the same token, surviving banks have grown quite large. If you've been with one bank over the past ten years or so, you've probably seen the name change at least once or twice.

Savings Banks

Savings banks (also called *thrift institutions* and *savings and loan associations*, or *S&Ls*) were originally set up to encourage personal saving and provide mortgages to local home buyers. Today, however, they provide a range of services similar to those offered by commercial banks. Though not as dominant as commercial banks, they're an important component of the industry, holding total financial assets of almost \$1.5 trillion (10 percent of the total assets of the banking institutions).³⁵⁰ The largest S&L, Sovereign Bancorp, has close to 750 branches in nine Northeastern states.³⁵¹ Savings banks can be owned by their depositors (mutual ownership) or by shareholders (stock ownership).

Credit Unions

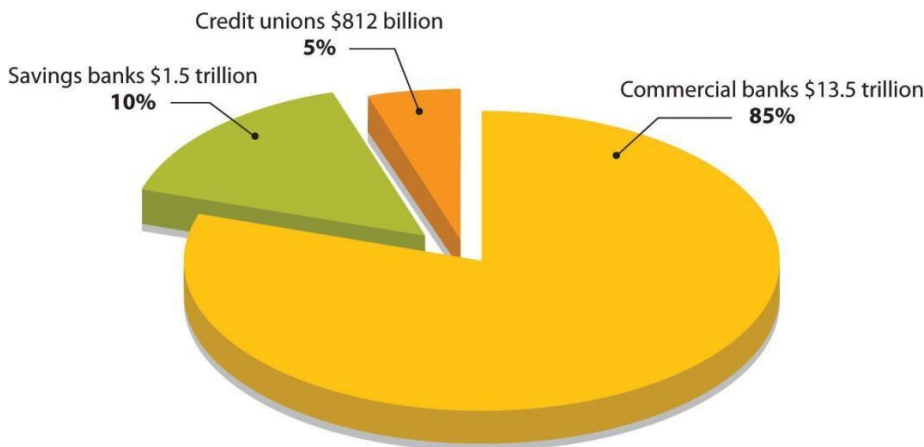


Figure 91 Where Our Money Is Deposited

To bank at a credit union, you must be linked to a particular group, such as employees of United Airlines, employees of the state of North Carolina, teachers in Pasadena, California, or current and former

members of the U.S. Navy. Credit unions are owned by their members, who receive shares of their profits. They offer almost anything that a commercial bank or savings and loan does, including savings accounts, checking accounts, home and car loans, credit cards, and even some commercial loans.³⁵² Collectively, they hold about \$812 billion in financial assets (around 5 percent of the total assets of the financial institutions). Figure 2 "Where Our Money Is Deposited" summarizes the distribution of assets among the nation's depository institutions.

Finance Companies

Finance companies are non-deposit institutions because they don't accept deposits from individuals or provide traditional banking services, such as checking accounts. They do, however, make loans to individuals and businesses, using funds acquired by selling securities or borrowed from commercial banks. They hold about \$1.9 trillion in assets.³⁵³ Those that lend money to businesses, such as General Electric Capital Corporation, are *commercial finance companies*, and those that make loans to individuals or issue credit cards, such as Citigroup, are *consumer finance companies*. Some, such as General Motors Acceptance Corporation, provide loans to both consumers (car buyers) and businesses (GM dealers).

Insurance Companies

Insurance companies sell protection against losses incurred by illness, disability, death, and property damage. To finance claims payments, they collect premiums from policyholders, which they invest in stocks, bonds, and other assets. They also use a portion of their funds to make loans to individuals, businesses, and government agencies.

Brokerage Firms

Companies like A.G. Edwards & Sons and T. Rowe Price, which buy and sell stocks, bonds, and other investments for clients, are brokerage firms (also called *securities investment dealers*). A mutual fund invests money from a pool of investors in stocks, bonds, and other securities. Investors become part owners of the fund. Mutual funds reduce risk by diversifying investment: because assets are invested in dozens of companies in a variety of industries, poor performance by some firms is usually offset by good performance by others. Mutual funds may be stock funds, bond funds, and money market funds, which invest in safe, highly liquid securities. (Recall our definition of *liquidity*

in Chapter 12 "The Role of Accounting in Business" as the speed with which an asset can be converted into cash.) Finally, pension funds, which manage contributions made by participating employees and employers and provide members with retirement income, are also no deposit institutions.

Financial Services

You can appreciate the diversity of the services offered by commercial banks, savings banks, and credit unions by visiting their Web sites. For example, Wells Fargo promotes services to four categories of customers: individuals, small businesses, corporate and institutional clients, and affluent clients seeking "wealth management." In addition to traditional checking and savings accounts, the bank offers automated teller machine (ATM) services, credit cards, and debit cards. It lends money for homes, cars, college, and other personal and business needs. It provides financial advice and sells securities and other financial products, including individual retirement account (IRA), by which investors can save money that's tax free until they retire. Wells Fargo even offers life, auto, disability, and homeowners insurance. It also provides electronic banking for customers who want to check balances, transfer funds, and pay bills online.³⁵⁴

Bank Regulation

How would you react if you put your life savings in a bank and then, when you went to withdraw it, learned that the bank had failed—that your money no longer existed? This is exactly what happened to many people during the Great Depression. In response to the crisis, the federal government established the Federal Deposit Insurance Corporation (FDIC) in 1933 to restore confidence in the banking system. The FDIC insures deposits in commercial banks and savings banks up to \$250,000. So today if your bank failed, the government would give you back your money (up to \$250,000). The money comes from fees charged member banks.

To decrease the likelihood of failure, various government agencies conduct periodic examinations to ensure that institutions are in compliance with regulations. Commercial banks are regulated by the FDIC, savings banks by the Office of Thrift Supervision, and credit unions by the National Credit Union Administration. As we'll see later in the chapter, the Federal Reserve System also has a strong influence on the banking industry.

Crisis in the Financial Industry (and the Economy)

What follows is an interesting, but scary, story about the current financial crisis in the banking industry and its effect on the economy. In the years between 2001 and 2005, lenders made billions of dollars in subprime adjustable-rate mortgages (ARMs) to American home buyers. Subprime loans are made to home buyers who don't qualify for market-set interest rates because of one or more risk factors—income level, employment status, credit history, ability to make only a very low down payment. In 2006 and 2007, however, housing prices started to go down. Many homeowners with subprime loans, including those with ARMs whose rates had gone up, were able neither to refinance (to lower their interest rates) nor to borrow against their homes. Many of these homeowners got behind in mortgage payments, and foreclosures became commonplace—1.3 million in 2007 alone.³⁵⁵ By April 2008, 1 in every 519 American households had received a foreclosure notice.³⁵⁶ By August, 9.2 percent of the \$12 trillion in U.S. mortgage loans was delinquent or in foreclosure.³⁵⁷

The repercussions? Banks and other institutions that made mortgage loans were the first sector of the financial industry to be hit. Largely because of mortgage-loan defaults, profits at more than 8,500 U.S. banks dropped from \$35 billion in the fourth quarter of 2006 to \$650 million in the corresponding quarter of 2007 (a decrease of 89 percent). Bank earnings for the year 2007 declined 31 percent and dropped another 46 percent in the first quarter of 2008.³⁵⁸

Losses in this sector were soon felt by two publicly traded government-sponsored organizations, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Both of these institutions are authorized to make loans and provide loan guarantees to banks, mortgage companies, and other mortgage lenders; their function is to make sure that these lenders have enough money to lend to prospective home buyers. Between them, Fannie Mae and Freddie Mac backed approximately half of that \$12 trillion in outstanding mortgage loans, and when the mortgage crisis hit, the stock prices of the two corporations began to drop steadily. In September 2008, amid fears that both organizations would run out of capital, the U.S. government took over their management.

Freddie Mac also had another function: to increase the supply of money available in the country for mortgage loans and new home purchases, Freddie Mac bought mortgages from banks, bundled these mortgages, and sold the bundles to investors (as mortgage-backed securities). The investors earned a return because they received cash from the monthly mortgage payments. The banks that originally sold the mortgages to Freddie Mac used the cash they got from the sale to make other loans. So investors earned a return, banks got a new influx of cash to make more loans, and individuals were able to get mortgages to buy the homes they wanted. This seemed like a good deal for everyone, so many major investment firms started doing the same thing: they bought individual subprime mortgages from original lenders (such as small banks), then pooled the mortgages and sold them to investors.

But then the bubble burst. When many home buyers couldn't make their mortgage payments (and investors began to get less money and consequently their return on their investment went down), these mortgage-backed securities plummeted in value. Institutions that had invested in them—including investment banks—suffered significant losses.³⁵⁹ In September 2008, one of these investment banks, Lehman Brothers, filed for bankruptcy protection; another, Merrill Lynch, agreed to sell itself for \$50 billion. Next came American International Group (AIG), a giant insurance company that insured financial institutions against the risks they took in lending and investing money. As its policyholders buckled under the weight of defaulted loans and failed investments, AIG, too, was on the brink of bankruptcy, and when private efforts to bail it out failed, the U.S. government stepped in with a loan of \$85 billion.³⁶⁰ The U.S. government also agreed to buy up risky mortgage-backed securities from teetering financial institutions at an estimated cost of “hundreds of billions.”³⁶¹ And the banks started to fail—beginning with the country's largest savings and loan, Washington Mutual, which had 2,600 locations throughout the country. The list of failed banks kept getting longer: by November of 2008, it had grown to nineteen.

The economic troubles that began in the banking industry as a result of the subprime crisis spread to the rest of the economy. Credit markets froze up and it became difficult for individuals and businesses to borrow money. Consumer confidence dropped, people stopped spending, businesses cut production, sales dropped, company profits fell, and many lost their jobs. It would be nice if this story had an ending (and even nicer if it was

positive), but it might take us years before we know the ending. At this point in time, all we do know is that the economy is going through some very difficult times and no one is certain about the outcome. As we head into 2012, one in three Americans believe the United States is headed in the wrong direction. Our debt has been downgraded by Moody's, a major credit rating agency. Unemployment seems stuck at around 9 percent, with the long-term unemployed making up the biggest portion of the jobless since records began in 1948. "As the superpower's clout seems to ebb towards Asia, the world's most consistently inventive and optimistic country has lost its mojo."³⁶²

How Banks Expand the Money Supply

When you deposit money, your bank doesn't set aside a special pile of cash with your name on it. It merely records the fact that you made a deposit and increases the balance in your account. Depending on the type of account, you can withdraw your share whenever you want, but until then, it's added to all the other money held by the bank. Because the bank can be pretty sure that all its depositors won't withdraw their money at the same time, it holds on to only a fraction of the money that it takes in—its *reserves*. It lends out the rest to individuals, businesses, and the government, earning interest income and expanding the money supply.

The Money Multiplier

Precisely how do banks expand the money supply? To find out, let's pretend you win \$10,000 at the blackjack tables of your local casino. You put your winnings into your savings account

immediately. The bank will keep a fraction of your \$10,000 in reserve; to keep matters simple, we'll use 10 percent. The bank's reserves, therefore, will increase by \$1,000 ($\$10,000 \times 0.10$). It will then

lend out the remaining \$9,000. The borrowers (or the parties to whom they pay it out) will then deposit the \$9,000 in their own banks. Like your bank, these banks will hold onto 10

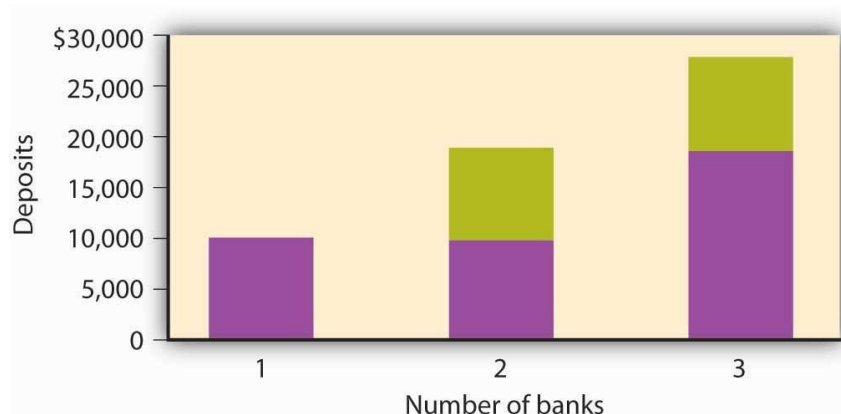


Figure 92 The Effect of the Money Multiplier

percent of the money (\$900) and lend out the remainder (\$8,100). Now let's go through the process one more time. The borrowers of the \$8,100 (or, again, the parties to whom they pay it out) will put this amount into their banks, which will hold onto \$810 and lend the remaining \$7,290. As you can see in Figure 3 "The Effect of the Money Multiplier", total bank deposits would now be \$27,100. Eventually, bank deposits would increase to \$100,000, bank reserves to \$10,000, and loans to \$90,000. A shortcut for arriving at these numbers depends on the concept of the money multiplier, which is determined using the following formula:

$$\text{Money multiplier} = 1/\text{Reserve requirement}$$

In our example, the money multiplier is $1/0.10 = 10$. So your initial deposit of \$10,000 expands into total deposits of \$100,000 ($\$10,000 \times 10$), additional loans of \$90,000 ($\$9,000 \times 10$), and increased bank reserves of \$10,000 ($\$1,000 \times 10$). In reality, the multiplier will actually be less than 10. Why? Because some of the money loaned out will be held as currency and won't make it back into the banks.

Key Takeaways

- Financial institutions serve as financial intermediaries between savers and borrowers and direct the flow of funds between the two groups.
- Those that accept deposits from customers—depository institutions—include **commercial banks**, **savings banks**, and **credit unions**; those that don't—no depository institutions—include **finance companies**, **insurance companies**, and **brokerage firms**.
- 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 onto only a fraction of the money that it takes in—an amount called its **reserves**—and lends the rest out 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.

The Federal Reserve System

Learning Outcome

1. Identify the goals of the Federal Reserve System and explain how it uses monetary policy to control the money supply and influence interest rates.

Who decides how much banks should keep in reserve? The decision is made by the Federal Reserve System (popularly known as “the Fed”), a central banking system established in 1913. Most large banks belong to the Federal Reserve System, which divides the country into twelve districts, each with a member-owned Federal Reserve Bank. The twelve banks are coordinated by a board of governors.

The Tools of the Fed

The Fed has three major goals:³⁶³

1. Price stability
2. Sustainable economic growth
3. Full employment

Recall our definition of *monetary policy* in Chapter 1 “The Foundations of Business” as the efforts of the Federal Reserve System to regulate the nation’s money supply. We also defined *price stability* as conditions under which the prices for products remain fairly constant. Now, we can put the two concepts together: the Fed seeks to stabilize prices by regulating the money supply and interest rates. In turn, stable prices promote economic growth and full employment—at least in theory. To conduct monetary policy, the Fed relies on three tools: *reserve requirements*, the *discount rate*, and *open market operations*.

Reserve Requirements

Under what circumstances would the Fed want to change the reserve requirement for banks? The purpose of controlling the money supply is primarily to lessen the threat of *inflation* (a rise in the overall price level) or *recession* (an economic slowdown gauged by a decline in gross domestic product). Here’s how it works (again, in theory). If the Fed *raises* the reserve requirement (for example, from 10 percent to 11 percent), banks must set aside more money. Consequently, they have *less to lend* and so raise their interest rates.

Under these conditions, it's harder and more expensive for people to borrow money, and if they can't borrow as much, they can't spend as much, and if people don't spend as much, prices don't go up. Thus, the Fed has lessened the likelihood of inflation.

Conversely, when the Fed *lowers* the reserve requirement (for example, from 10 percent to 9 percent), banks need to set aside less money. Because they have *more money to lend*, they keep interest rates down. Borrowers find it easier and cheaper to get money for buying things, and the more consumers buy, the higher prices go. In this case, the Fed has reduced the likelihood of a recession.

A 1 percent change in the reserve requirement, whether up to 11 percent or down to 9 percent, may not seem like much, but remember our earlier discussion of the *money multiplier*: because of the money-multiplier effect, a small change in the reserve requirement has a dramatic effect on the money supply. (For the same reason, the Fed changes reserve requirements only rarely.)

The Discount Rate

To understand how the Fed uses the discount rate to control the money supply, let's return to our earlier discussion of reserves. Recall that banks must keep a certain fraction of their deposits as reserves. The bank can hold these reserve funds or deposit them into a Federal Reserve Bank account. Recall, too, that the bank can lend out any funds that it doesn't have to put on reserve. What happens if a bank's reserves fall below the required level? The Fed steps in, permitting the bank to "borrow" reserve funds from the Federal Reserve Bank and add them to its reserve account at the Bank. There's a catch: the bank must pay interest on the borrowed money. The rate of interest that the Fed charges member banks is called the discount rate. By manipulating this rate, the Fed can make it appealing or unappealing to borrow funds. If the rate is high enough, banks will be reluctant to borrow. Because they don't want to drain their reserves, they cut back on lending. The money supply, therefore, decreases. By contrast, when the discount rate is low, banks are more willing to borrow because they're less concerned about draining their reserves. Holding fewer excess reserves, they lend out a higher percentage of their funds, thereby increasing the money supply. Even more important is the carryover effect of a change in the discount rate to the overall level of interest rates.³⁶⁴ When the Fed adjusts

the discount rate, it's telling the financial community where it thinks the economy is headed—up or down. Wall Street, for example, generally reacts unfavorably to an increase in the discount rate. Why? Because the increase means that interest rates will probably rise, making future borrowing more expensive.

Open Market Operations

The Fed's main tool for controlling the money supply and influencing interest rates is called open market operations: the sale and purchase of U.S. government bonds by the Fed in the open market. To understand how this process works, we first need to know a few facts:

- The Fed's assets include a substantial dollar amount of government bonds.
- The Fed can buy or sell these bonds on the open market (consisting primarily of commercial banks).
- Because member banks use cash to buy these bonds, they decrease their reserve balances when they buy them.
- Because member banks receive cash from the sale of the bonds, they increase their reserve balances when they sell them.
- Banks must maintain a specified balance in reserves; if they dip below this balance, they have to make up the difference by borrowing money.

If the Fed wants to decrease the money supply, it can *sell* bonds, thereby reducing the reserves of the member banks that buy them. Because these banks would then have less money to lend, the money supply would decrease. If the Fed wants to increase the money supply, it will *buy* bonds, increasing the reserves of the banks that sell them. The money supply would increase because these banks would then have more money to lend.

The Federal Funds Rate

In conducting open market operations, the Fed is trying to do the same thing that it does in using its other tools—namely, to influence the money supply and, thereby, interest rates. But it also has something else in mind. To understand what that is, you need to know a few more things about banking. When a bank's reserve falls below its required level, it may, as we've seen, borrow from the Fed (at the discount rate). But it can also borrow from other member banks that have excess reserves. The rate that banks pay when they borrow through this channel is called the federal funds rate.³⁶⁵

How does the federal funds rate affect the money supply? As we've seen, when the Fed sells bonds in the open market, the reserve balances of many member banks go down. To get their reserves back to the required level, they must borrow, whether from the Fed or from other member banks. When Bank 1 borrows from Bank 2, Bank 2's supply of funds goes down; thus, it increases the interest rate that it charges. In short, the increased demand for funds drives up the federal funds rate.

All this interbank borrowing affects you, the average citizen and consumer. When the federal funds rate goes up, banks must pay more for their money, and they'll pass the cost along to their customers: banks all over the country will raise the interest rates charged on mortgages, car loans, and personal loans. Figure charts ten-year fluctuations in the discount rate, federal funds rate, and prime rate—the rate that banks charge their best customers. Because all three rates tend to move in the same direction, borrowers—individuals, as well as organizations—generally pay more to borrow money when banks have to pay more and less when banks have to pay less. Notice that the prime rate (which banks charge their customers) is higher than both the federal funds and discount rates (which banks must pay when they need to borrow). That's why banks make profits when they make loans. Note, too, that the Fed lowered the discount rate and federal funds rate drastically in 2008 in an attempt to stimulate a weakening economy. Despite continued low rates through 2011, the economy is still very weak.

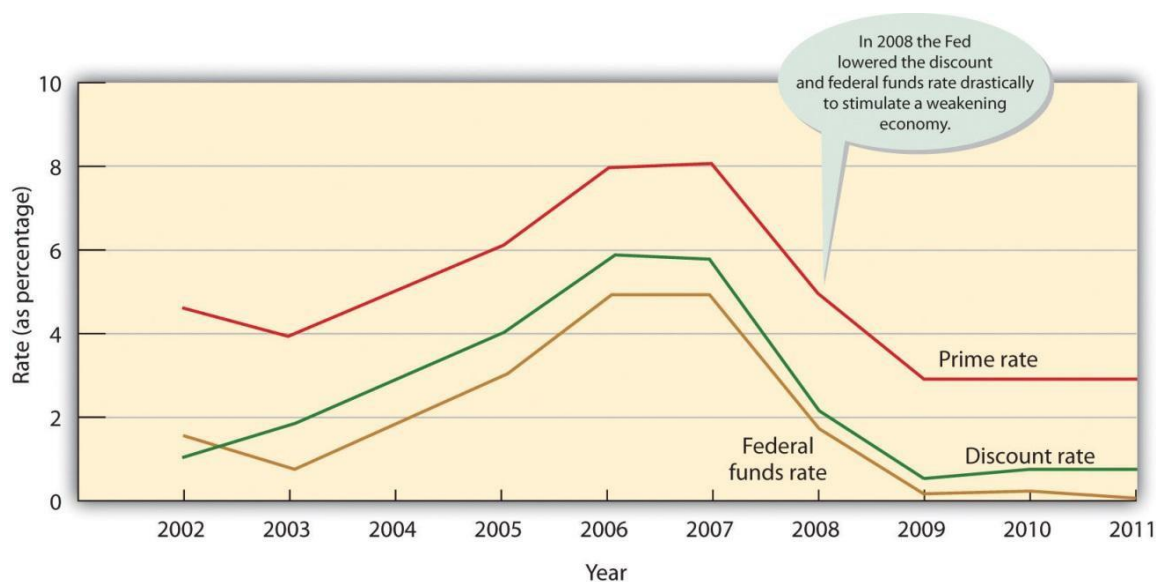


Figure 93 Key Interest Rates, 2002–2011

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The Banker's Bank and the Government's Banker

The Fed performs another important function: it serves its member banks in much the same way as your bank serves you. When you get a check, you deposit it in your checking account, thereby increasing your balance. When you pay someone by check, the dollar amount of the check is charged to your account, and your balance goes down. The Fed works in much the same way, except that its customers are member banks. Just as your bank clears your check, the Fed clears the checks that pass through its member banks. The monumental task of clearing more than fifteen billion checks a year is complicated by the fact that there are twelve district banks. If someone in one district (for example, Boston) writes a check to a payee in another district (say, San Francisco), the check must be processed through both districts.³⁶⁶

Prior to 2004, clearing checks took days because the checks themselves needed to be physically moved through the system. But thanks to the passage of Check 21 (a U.S. federal law), things now move much more quickly. Instead of physically transporting checks, banks are allowed to make an image of the front and back of a check and send the digital version of the original check, called a “substitute” check, through the system electronically.³⁶⁷ The good news is that Check 21 shortened the time it takes to clear a check, often down to one day. The bad news is that Check 21 shortened the time it takes to clear a check, which increases the risk that a check you write will bounce. So be careful: don't write a check unless you have money in the bank to cover it. In performing the following functions, the Fed is also the U.S. government's banker:

- Holding the U.S. Treasury's checking account
- Processing the paperwork involved in buying and selling government securities
- Collecting federal tax payments
- Lending money to the government by purchasing government bonds from the Treasury

The Fed also prints, stores, and distributes currency and destroys it when it's damaged or worn out. Finally, the Fed, in conjunction with other governmental agencies, supervises and regulates financial institutions to ensure that they operate soundly and treat customers fairly and equitably.³⁶⁸

Key Takeaways

- 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:
 1. it can raise or lower reserve requirements—the percentage of its funds that banks must set aside and can’t lend out;
 2. it can raise or lower the **discount rate**—the rate of interest that the Fed charges member banks to borrow “reserve” funds;
 3. it can conduct **open market operations**—buying or selling government securities on the open market.

The Role of the Financial Manager

Learning Outcomes

1. Explain the ways in which a new business gets start-up cash.
2. Identify approaches used by existing companies to finance operations and growth.

So far, we’ve focused our attention on the financial environment in which U.S. businesses operate. Now let’s focus on the role that finance plays within an organization. In Chapter 1 “The Foundations of Business”, we defined *finance* as all the activities involved in planning for, obtaining, and managing a company’s funds. We also explained that a *financial manager* determines how much money the company needs, how and where it will get the necessary funds, and how and when it will repay the money that it has borrowed. The financial manager also decides what the company should do with its funds—what investments should be made in plant and equipment, how much should be spent on research and development, and how excess funds should be invested.

Financing a New Company

Because new businesses usually need to borrow money in order to get off the ground,

good financial management is particularly important to start-ups. Let's suppose that you're about to start up a company that you intend to run from your dorm room. You thought of the idea while rummaging through a pile of previously worn clothes to find something that wasn't about to get up and walk to the laundry all by itself. "Wouldn't it be great," you thought, "if there was an on-campus laundry service that would come and pick up my dirty clothes and bring them back to me washed and folded." Because you were also in the habit of running out of cash at inopportune times, you were highly motivated to start some sort of money-making enterprise, and the laundry service seemed to fit the bill (even though washing and folding clothes wasn't among your favorite activities—or skills).

Developing a Financial Plan

Because you didn't want your business to be so small that it stayed under the radar of fellow students and potential customers, you knew that you'd need to raise funds to get started. So what are your cash needs? To answer this question, you need to draw up a financial plan—a document that performs two functions:

1. Calculating the amount of funds that a company needs for a specified period
2. Detailing a strategy for getting those funds

Estimating Sales

Fortunately, you can draw on your newly acquired accounting skills to prepare the first section—the one in which you'll specify the amount of cash you need. You start by estimating your *sales* (or, in your case, revenue from laundering clothes) for your first year of operations. This is the most important estimate you'll make: without a realistic sales estimate, you can't accurately calculate equipment needs and other costs. To predict sales, you'll need to estimate two figures:

1. The number of loads of laundry that you'll handle
2. The price that you'll charge per load

You calculate as follows: You estimate that 5 percent of the ten thousand students on campus will use the service. These five hundred students will have one large load of laundry for each of the thirty-five weeks that they're on campus. Therefore, you'll do 17,500 loads ($500 \times 35 = 17,500$ loads). You decide to price each load at \$10. At first, this

seemed high, but when you consider that you'll have to pick up, wash, dry, fold, and return large loads, it seems reasonable.

Perhaps more important, when you projected your costs—including salaries (for some student workers), rent, utilities, depreciation on equipment and a truck, supplies, maintenance, insurance, and advertising—you found that each load would cost \$8, leaving a profit of \$2 per load and earning you \$35,000 for your first year (which is worth your time, though not enough to make you rich).

What things will you have to buy in order to get started? Using your estimate of sales, you've determined that you'd need the following:

- Five washers and five dryers
- A truck to pick up and deliver the clothes (a used truck will do for now)
- An inventory of laundry detergent and other supplies, such as laundry baskets
- Rental space in a nearby building (which will need some work to accommodate a laundry)

And, you'll need cash—cash to carry you over while the business gets going and cash with which to pay your bills. Finally, you'd better have some extra money for contingencies—things you don't expect, such as a machine overflowing and damaging the floor. You're mildly surprised to find that your cash needs total \$33,000. Your next task is to find out where you can get \$33,000. In the next section, we'll look at some options.

Getting the Money

Figure 5 "Where Small Businesses Get Funding" summarizes the results of a survey in which owners of small and medium-size businesses were asked where they typically acquired their financing. To simplify matters, we'll work on the principle that new businesses are generally financed with some combination of the following:

- Owners' personal assets
- Loans from families and friends
- Bank loans (including those guaranteed by the Small Business Development Center)

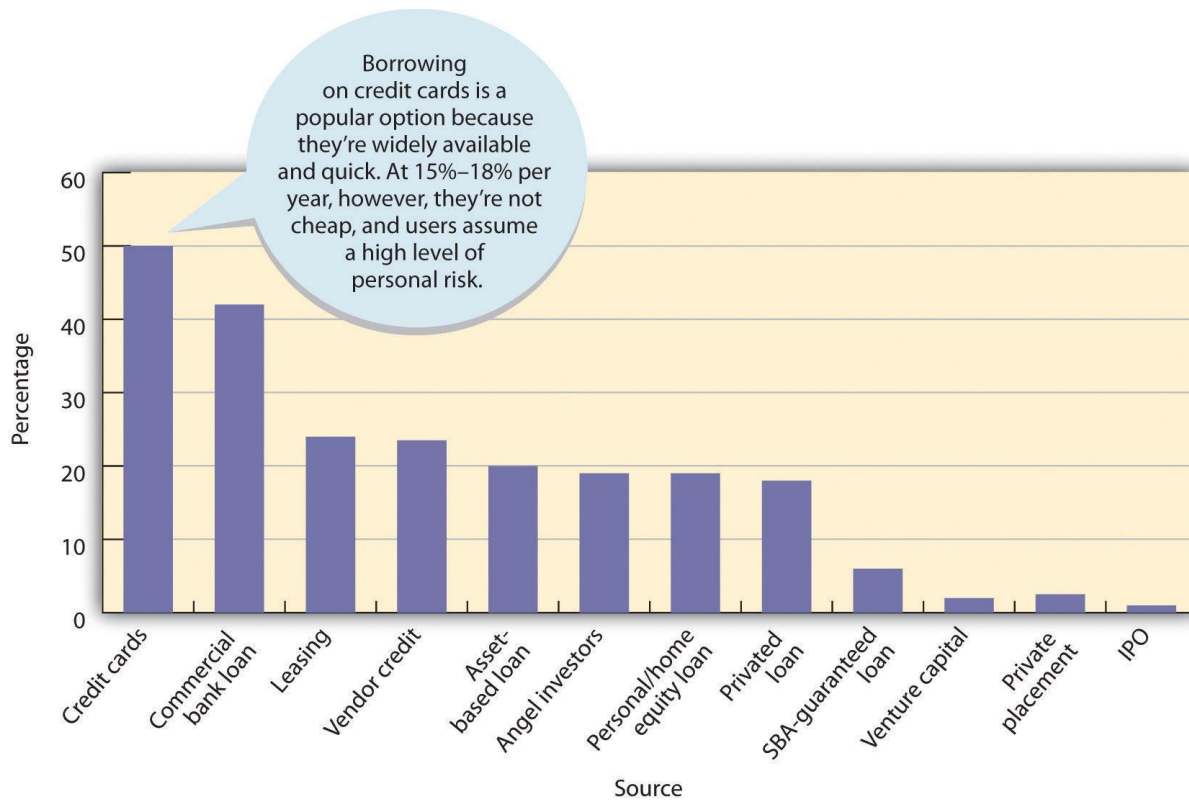


Figure 94 Where Small Businesses Get Funding

Remember that during its start-up period, a business needs a lot of cash: it not only will incur substantial start-up costs, but may even suffer initial operational losses.

Personal Assets

Its owners are the most important source of funds for any new business. Figuring that owners with substantial investments will work harder to make the enterprise succeed, lenders expect owners to put up a substantial amount of the start-up money. Where does this money come from? Usually through personal savings, credit cards, home mortgages, or the sale of personal assets.

Loans from Family and Friends

For many entrepreneurs, the next step is family and friends. If you have an idea with commercial potential, you might be able to get family members and friends either to invest in it (as part owners) or to lend you some money. Remember that family and friends are like any other creditors: they expect to be repaid, and they expect to earn interest. Even when you're borrowing from family members or friends, you should draw up a formal loan agreement stating when the loan will be repaid and specifying the interest rate.

Bank Loans

The financing package for a start-up company will probably include bank loans. Banks, however, will lend you some start-up money only if they're convinced that your idea is commercially feasible. They also prefer you to have some combination of talent and experience to run the company successfully. Bankers want to see a well-developed business plan, with detailed financial projections demonstrating your ability to repay loans. Financial institutions offer various types of loans with different payback periods. Most, however, have a few common characteristics.

Maturity

The period for which a bank loan is issued is called its maturity. A short-term loan is for less than a year, an intermediate loan for one to five years, and a long-term loan for five years or more. Banks can also issue lines of credit that allow you to borrow up to a specified amount as the need arises (it's a lot like the limit on your credit card). In taking out a loan, you want to match its term with its purpose. If, for example, you're borrowing money to buy a truck that you plan to use for five years, you'd request a five-year loan. On the other hand, if you're financing a piece of equipment that you'll use for ten years, you'll want a ten-year loan. For short-term needs, like buying inventory, you may request a one-year loan.

With any loan, however, you must consider the ability of the business to repay it. If you expect to lose money for the first year, you obviously won't be able to repay a one-year loan on time. You'd be better off with intermediate or long-term financing. Finally, you need to consider amortization—the schedule by which you'll reduce the balance of your debt. Will you be making periodic payments on both principal and interest over the life of the loan (for example, monthly or quarterly), or will the entire amount (including interest) be due at the end of the loan period?

Security

A bank won't lend you money unless it thinks that your business can generate sufficient funds to pay it back. Often, however, the bank takes an added precaution by asking you for security—business or personal assets, called collateral, that you pledge in order to guarantee repayment. You may have to secure the loan with company assets, such as inventory or accounts receivable, or even with personal assets. (Likewise, if you're an

individual getting a car loan, the bank will accept the automobile as security.) In any case, the principle is pretty simple: if you don't pay the loan when it's due, the bank can take possession of the collateral, sell it, and keep the proceeds to cover the loan. If you don't have to put up collateral, you're getting an unsecured loan, but because of the inherent risk entailed by new business ventures, banks don't often make such loans.

Interest

Interest is the cost of using someone else's money. The rate of interest charged on a loan varies with several factors—the general level of interest rates, the size of the loan, the quality of the collateral, and the debt-paying ability of the borrower. For smaller, riskier loans, it can be as much as 6 to 8 percentage points above the prime rate—the rate that banks charge their most creditworthy borrowers. It's currently around 3 percent per year.

Making the Financing Decision

Now that we've surveyed your options, let's go back to the task of financing your laundry business. You'd like to put up a substantial amount of the money you need, but you can only come up with a measly \$1,000 (which you had to borrow on your credit card). You were, however, able to convince your parents to lend you \$10,000, which you've promised to pay back, with interest, in three years. (They were wavering until you pointed out that Fred DeLuca started SUBWAY as a way of supporting himself through college).

So you still need \$22,000 (\$33,000 minus the \$11,000 from you and your parents). You talked with someone at the Small Business Development Center located on campus, but you're not optimistic about getting them to guarantee a loan. Instead, you put together a sound business plan, including projected financial statements, and set off to your local banker. To your surprise, she agreed to a five-year loan at a reasonable interest rate. Unfortunately, she wanted the entire loan secured. Because you're using some of the loan money to buy washers and dryers (for \$15,000) and a truck (for \$6,000), you can put up these as collateral. You have no accounts receivable or inventories, so you agreed to put up some personal assets—namely, the shares of Microsoft stock that you got as a high-school graduation present (now worth about \$5,000).

Financing the Business During the Growth Stage

Flash-forward two and a half years: much to your delight, your laundry business took off.

You had your projected five hundred customers within six months, and over the next few years, you expanded to four other colleges in the geographical area. Now you're serving five colleges and some three thousand customers a week. Your management team has expanded, but you're still in charge of the company's finances. In the next sections, we'll review the tasks involved in managing the finances of a high-growth business.

Managing Cash

Cash-flow management means monitoring cash inflows and outflows to ensure that your company has sufficient—but not excessive—cash on hand to meet its obligations. When projected cash flows indicate a future shortage, you go to the bank for additional funds. When projections show that there's going to be idle cash, you take action to invest it and earn a return for your company.

Managing Accounts Receivable

Because you bill your customers every week, you generate sizable *accounts receivable*—money that you'll receive from customers to whom you've sold your service. You make substantial efforts to collect receivables on a timely basis and to keeping nonpayment to a minimum.

Managing Accounts Payable

Accounts payable are records of cash that you owe to the suppliers of products that you use. You generate them when you buy supplies with trade credit—credit given you by your suppliers. You're careful to pay your bills on time, but not ahead of time (because it's in your best interest to hold on to your cash as long as possible).

Budgeting

A budget is a preliminary financial plan for a given time period, generally a year. At the end of the stated period, you compare actual and projected results and then you investigate any significant discrepancies. You prepare several types of budgets: projected financial statements, a cash budget that projects cash flows, and a capital budget that shows anticipated expenditures for major equipment.

Seeking Out Private Investors

So far, you've been able to finance your company's growth through internally generated funds—profits retained in the business—along with a few bank loans. Your success,

especially your expansion to other campuses, has confirmed your original belief that you've come up with a great business concept. You're anxious to expand further, but to do that, you'll need a substantial infusion of new cash. You've poured most of your profits back into the company, and your parents can't lend you any more money. After giving the problem some thought, you realize that you have three options:

1. Ask the bank for more money.
2. Bring in additional owners who can invest in the company.
3. Seek funds from a private investor.

Angels and Venture Capitalists

Eventually, you decide on the third option. First, however, you must decide what type of private investor you want—an “angel” or a venture capitalist. Angels are usually wealthy individuals willing to invest in *start-up ventures* they believe will succeed. They bet that a business will ultimately be very profitable and that they can sell their interest at a large profit. Venture capitalists pool funds from private and institutional sources (such as pension funds and insurance companies) and invest them in *existing businesses* with strong growth potential. They're typically willing to invest larger sums but often want to cash out more quickly than angels.

There are drawbacks. Both types of private investors provide business expertise, as well as financing, and, in effect, both become partners in the enterprises that they finance. They accept only the most promising opportunities, and if they do decide to invest in your business, they'll want something in return for their money—namely, a say in how you manage it.

When you approach private investors, you can be sure that your business plan will get a thorough going-over. Under your current business model, setting up a new laundry on another campus requires about \$50,000. But you're a little more ambitious, intending to increase the number of colleges that you serve from five to twenty-five. So you'll need a cash inflow of \$1 million. On weighing your alternatives and considering the size of the loan you need, you decide to approach a venture capitalist. Fortunately, because you prepared an excellent business plan and made a great presentation, your application was accepted. Your expansion begins.

Going Public

Fast-forward another five years. You've worked hard (and been lucky), and even finished your degree in finance. Moreover, your company has done amazingly well, with operations at more than five hundred colleges in the Northeast. You've financed continued strong growth with a combination of venture-capital funds and internally generated funds (that is, reinvested earnings).

Up to this point, you've operated as a privately held corporation with limited stock ownership (you and your parents are the sole shareholders). But because you expect your business to prosper even more and grow even bigger, you're thinking about the possibility of selling stock to the public for the first time. The advantages are attractive: not only would you get a huge influx of cash, but because it would come from the sale of stock rather than from borrowing, it would also be interest free and you wouldn't have to repay it. Again there are some drawbacks. For one thing, going public is quite costly—often exceeding \$300,000—and time-consuming. Second, from this point on, your financial results would be public information. Finally, you'd be responsible to shareholders who will want to see the kind of short-term performance results that boosts stock prices.

After weighing the pros and cons, you decide to go ahead. The first step in the process of becoming a publicly traded corporation is called an initial public offering (IPO), and you'll need the help of an investment banking firm—a financial institution (such as Goldman Sachs or Morgan Stanley) that specializes in issuing securities. Your investment banker advises you that now's a good time to go public and determines the best price at which to sell your stock. Then, you'll need the approval of the Securities and Exchange Commission (SEC), the government agency that regulates securities markets.

Key Takeaways

- If a new business hopes to get funding, it should prepare a financial plan—a document that shows the amount of capital that it needs for a specified period, how and where it will get it, and how and when it will pay it back.
- Common sources of funding for new businesses include personal assets, loans from family and friends, and bank loans.

- Financial institutions offer business loans with different **maturities**. A **short-term loan** matures in less than a year, an **intermediate loan** in one to five years, and a **long-term loan** after five years or more.
- Banks also issue **lines of credit** that allow companies to borrow up to a specified amount as the need arises.
- Banks generally require **security** in the form of **collateral**, such as company or personal assets. If the borrower fails to pay the loan when it's due, the bank can take possession of these assets.
- Existing companies that want to expand often seek funding from private investors. **Angels** are wealthy individuals who are willing to invest in ventures that they believe will succeed. **Venture capitalists**, though willing to invest larger sums of money, often want to cash out more quickly than angels. They generally invest in existing businesses with strong growth potential.
- Successful companies looking for additional capital might decide to go public, offering an initial sale of stock called an **initial public offering (IPO)**.

Understanding Securities Markets

Learning Outcomes

1. Show how the securities market operates and how it's regulated.
2. Understand how market performance is measured.

So, before long, you're a publicly traded company. Fortunately, because your degree in finance comes with a better-than-average knowledge of financial markets, you're familiar with the ways in which investors will evaluate your company. Investors will look at the overall quality of the company and ask some basic questions:

- How well is it managed?
- Is it in a growing industry? Is its market share increasing or decreasing?
- Does it have a good line of products? Is it coming out with innovative products?
- How is the company doing relative to its competitors?
- What is its future? What is the future of its industry?

Investors also analyze the company's performance over time and ask more-specific questions:

- Are its sales growing?
- Is its income going up?
- Is its stock price rising or falling?
- Are earnings per share rising?

They'll assess the company's financial strength, asking another series of specific questions:

- Can it pay its bills on time?
- Does it have too much debt?
- Is it managing its productive assets (such as inventory) efficiently?

Primary and Secondary Markets and Stock Exchanges

Security markets serve two functions:

1. They help companies to raise funds by making the initial sale of their stock to the public.
2. They provide a place where investors can trade already issued stock.

When you went through your IPO, shares were issued through a primary market—a market that deals in new financial assets. As we've seen, the sale was handled by an investment banking firm, which matched you, as a corporation with stock to sell, with investors who wanted to buy it.

Organized Exchanges

After a certain time elapsed, investors began buying and selling your stock on a secondary market. The proceeds of sales on this market go to the investor who sells the stock, not to your company. The best-known of these markets is the New York Stock Exchange (NYSE),³⁶⁹ where the stocks of the largest, most prestigious corporations in the world are traded. Other exchanges, including the American Stock Exchange (AMEX) and regional exchanges located in places like Chicago and Boston, trade the stock of smaller companies.

OTC Markets

Note that a “market” doesn’t have to be a physical location. In the over-the-counter (OTC) market, securities are traded among dealers over computer networks or by phone rather than on the floor of an organized exchange. Though there are exceptions, stocks traded in the OTC market are generally those of smaller (and often riskier) companies. The best-known OTC electronic-exchange system is the NASDAQ (National Association of Securities Dealers Automated Quotation system). It’s home to almost five thousand corporations, many of them technology companies. Unlike other OTC markets, the NASDAQ lists a variety of companies, ranging from small start-ups to such giants as Google, Microsoft, and Intel.

Regulating Securities Markets: The SEC

Because it’s vital that investors have confidence in the securities markets, Congress created the Securities and Exchange Commission (SEC) in 1934. The SEC is charged with enforcing securities laws designed to promote full public disclosure, protecting investors against misconduct in the securities markets, and maintaining the integrity of the securities markets.³⁷⁰

Before offering securities for sale, the issuer must register its intent to sell with the SEC. In addition, the issuer must provide prospective buyers with a prospectus—a written offer to sell securities that describes the business and operations of the issuer, lists its officers, provides financial information, discloses any pending litigation, and states the proposed use of funds from the sale.

The SEC also enforces laws against insider trading—the illegal buying or selling of its securities by a firm’s officers and directors or anyone else taking advantage of valuable information about the company before it’s made public. The intent of these laws is to prevent insiders from profiting at the expense of other investors.

Measuring Market Performance: Market Indexes

Throughout the day, you can monitor the general drift of the stock market by watching any major news network and following the band at the bottom of your TV. News channels and broadcasts generally feature a market recap in the evening. Even music-oriented radio stations break for a minute of news every now and then, including a quick review of the

stock market. Almost all these reports refer to one or more of the market indexes with which investors can track trends in stock price. Let's look more closely at some of these indicators.

The Dow

By far the most widely reported market index is the Dow Jones Industrial Average (DJIA), or "the Dow." The Dow is the total value of a "market basket" of thirty large companies headquartered in the United States. They aren't the thirty largest or best-performing companies, but rather a group selected by the senior staff members at the *Wall Street Journal* to represent a broad spectrum of the U.S. economy, as well as a variety of industries. The thirty selected stocks change over time, but the list usually consists of household names, such as AT&T, Coca-Cola, Disney, IBM, General Electric, and Wal-Mart.



Figure 95 DJIA for Ten-Year Period Ended November 2011

The graph in Figure 6 "DJIA for Ten-Year Period Ended November 2011" tracks the Dow for the ten-year period ended November 2011. The market measured by the

Dow was on an upward swing from 2002 until it peaked in October 2007 at its all-time high of 14,200. At that point, it headed down until it reached a low point in March 2008 of 6,500 (a 54 percent drop from its all-time high). It has since crawled back up to 12,000, which is still 15 percent below its previous high. The path of the DOW during this ten-year period has been very volatile (subject to up and down movements in response to unstable worldwide economic and political situations).³⁷¹

The NASDAQ Composite and the S&P 500

Also of interest is the performance of the NASDAQ Composite Index, which includes many

technology companies. Note in Figure 7 "NASDAQ for Ten-Year Period Ended November 2011" that the NASDAQ peaked in early 2000 at an index of over 5,000, but as investors began reevaluating the prospects of many technologies and technology companies, prices fell precipitously and the NASDAQ shed more than 80 percent of its value. It rebounded somewhat over the next seven years, only to be shot down again when difficult economic times in 2008 spelled trouble, and it declined by 45 percent. Another broad measure of stock performance is Standard and Poor's Composite Index (S&P 500), which lists the stocks of five hundred large U.S. companies. It followed the same pattern as the Dow and the NASDAQ Composite and declined by 37 percent in 2008.



Figure 96 NASDAQ for Ten-Year Period Ended November 2011

When the stock market is enjoying a period of large stock-price increases, we call it a bull market; when it's declining or sluggish, we call it a bear market. The year 2008 was definitely a bear market.

How to Read a Stock Listing

Businesspeople—both owners and managers—monitor their stock prices on a daily basis. They want the value of their stock to rise for both professional and personal reasons. Stock price, for example, is a sort of “report card” on the company's progress, and it reflects the success of its managers in running the company. Many managers have a great deal of personal wealth tied directly to the fortunes of the companies for which they work.

If you have any interest in investing, you'll want to know how to interpret stock market

information. Step one is learning how to read a stock listing like those printed daily in the *Wall Street Journal* and other newspapers as well as online at sites such as Yahoo! Finance and CNBC.³⁷² Figure 8 "Stock Listing for Hershey Foods" reports the information on Hershey Foods for November 8, 2011. Let's use the explanations in Table 1 "Interpreting a Stock Quotation" to examine each item in greater detail.

1		2	3	4	5	6	7	8	9
52-WEEK HI	LO	STOCK (SYMBOL)	DIV	YLD %	EPS	PE	VOL 100s	CLOSE	NET CHG
60.96	45.67	HSY	1.38	2.4	2.70	21	17,616	57.38	-20

Figure 97 Stock Listing for Hershey Foods

Table 9 Interpreting a Stock Quotation

STOCK SYMBOL	DESCRIPTION
52-WEEK HI	The highest price during the past year (November 8, 2010, to November 8, 2011) was \$60.96.
52-WEEK LO	The lowest price during the past year was \$45.67.
STOCK (SYMBOL)	The listing is for Hershey Foods, whose stock symbol is "HSY."
DIV	HSY pays an annual <i>dividend</i> of \$1.38 on each share of stock.
YLD %	HSY's dividend provides each investor with a 2.40 percent return (or <i>dividend yield</i>), as based on the day's closing stock price ($\$1.38 \div \$57.38 = 2.4\%$).
EARNINGS PER SHARE	EPS is total profits divided by the number of shares of common stock outstanding. EPS for Hershey for 2008 is \$ 2.70.

STOCK SYMBOL	DESCRIPTION
PE	The <i>price-earnings (PE) financial ratio</i> determines the amount that an investor would be willing to pay for every dollar of the company's earnings. This is a relative measure for comparing companies. For every \$1 of HSY's <i>earnings per share</i> (the company's annual income divided by the number of shares of stock), investors are willing to pay \$21 per share. High-growth firms usually have higher PE ratios, and vice versa.
VOL (100)	A common unit size for trading stocks is 100 shares, called a <i>round lot</i> . On November 8, 2011, 17,616 round lots were traded; in other words, the volume of HSY shares traded was 1.76 million shares (17,616 × 100).
CLOSE	HSY is traded on the New York Stock Exchange, which opens at 9:30 a.m. and closes at 4:00 p.m. every business day. Throughout the day, the price of HSY stock fluctuates, and at the end of the day, it stood at \$57.38.
NET CHG	The price of \$57.38 is down by \$0.20 from the previous trading day's close, which was \$57.58

What, exactly, does Hershey Foods' stock listing tell us? Here are some of the highlights: The stock has done poorly for the past twelve-month period. Its price has dropped by more than 25 percent. The closing stock price of \$57.38 falls right in the middle of the annual high of \$60.96 and the annual low of \$45.67. The company pays an annual dividend of \$1.38 per share (which gives investors a fairly good cash return on their stock of 2.40 percent). At its current PE ratio, investors are willing to pay \$21 for every \$1 of Hershey's earnings per share.

Key Takeaways

- Securities markets provide two functions:
 1. They help companies raise funds by making the initial sale of stock to the public.
 2. They provide a place where investors can trade previously issued stock.

- Stock sold through an IPO is issued through a **primary market** with the help of an **investment banking firm**.
- Previously issued securities are traded in a **secondary market**, where the proceeds from sales go to investors rather than to the issuing companies.
- The best-known exchanges are the **New York Stock Exchange**, the **American Stock Exchange**, and the **NASDAQ**.
- They're all regulated by the **Securities and Exchange Commission (SEC)**, a government agency that is charged with enforcing securities laws designed to protect the investing public.
- Stock market trends are measured by **market indexes**, such as the **Dow Jones Industrial Average (DJIA)**, the **NASDAQ Composite Index**, and **Standard & Poor's Composite Index (S&P 500)**.
- When the stock market is enjoying a period of large increases in prices, it's said to be in a **bull market**. When prices are declining, it's often called a **bear market**.

Financing the Going Concern

Learning Outcome

1. Define equity and debt financing, and discuss the advantages and disadvantages of each financing approach.

Let's assume that taking your company public was a smart move: in posing questions like those that we've just listed, investors have decided that your business is a good buy. With the influx of investment capital, the little laundry business that you started in your dorm ten

years ago has grown into a very large operation with laundries at more than seven hundred colleges all across the country, and you're opening two or three laundries a week. But there's still a huge untapped market out there, and you've just left a meeting with your board of directors at which it was decided that you'll seek additional funding for further growth. Everyone agrees that you need about \$8 million for the proposed expansion, yet there's a difference of opinion among your board members on how to go about getting it. You have two options:

1. Equity financing: raising the needed capital through the sale of stock
2. Debt financing: raising the needed capital by selling bonds

Let's review some of the basics underlying your options.

Stock

If you decide to sell stock to finance your expansion, the proceeds from the sale will increase your stockholders' equity—the amount invested in the business by its owners (which is the same thing that we called *owner's equity* in Chapter 12 "The Role of Accounting in Business"). In general, an increase in stockholders' equity is good. Your *assets*—specifically, your cash—will increase because you'll have more money with which to expand and operate your business (which is also good). But if you sell additional shares of stock, you'll have more stockholders—a situation that, as we'll see later, isn't always good.

The Risk/Reward Trade-Off

To issue additional shares of stock, you'll need to find buyers interested in purchasing them. You need to ask yourself this question: Why would anyone want to buy stock in your company? Stockholders, as we know, are part owners of the company and, as such, share in the risks and rewards associated with ownership. If your company does well, they may benefit through dividends—distributed earnings—or through appreciation in the value of their stock, or both. If your company does poorly, the value of their stock will probably decline. Because the risk/reward trade-off varies according to the type of stock—*common* or *preferred*—we need to know a little more about the difference between the two.

Common Stock

Holders of common stock bear the ultimate rewards and risks of ownership. Depending on the extent of their ownership, they could exercise some control over the corporation.

They're generally entitled to vote on members of the board of directors and other important matters. If the company does well, they benefit more than holders of preferred stock; if it does poorly, they take a harder hit. If it goes out of business, they're the last to get any money from the sale of what's left and can in fact lose their investments entirely.

So who would buy common stock? It's a good option for individuals and institutions that are willing to take an investment roller-coaster ride: for a chance to share in the growth and profits of a company (the ups), they have to be willing to risk losing all or part of their investments (the downs).

Preferred Stock

Preferred stock is safer, but it doesn't have the upside potential. Unlike holders of common stock, whose return on investment depends on the company's performance, preferred shareholders receive a fixed dividend every year. As usual, there are disadvantages and advantages. They don't usually have voting rights, and unless the company does extremely well, their dividends are limited to the fixed amount. On the other hand, they're *preferred* as to dividends: the company can pay no dividends to common shareholders until it's paid all preferred dividends. If the company goes under, preferred stockholders also get their money back before common shareholders get any of theirs. In many ways, they're more like creditors than investors in equity: though they can usually count on a fixed, relatively safe income, they have little opportunity to share in a company's success.

Cumulative and Convertible Preferred Stock

There are a couple of ways to make preferred stock more attractive. With cumulative preferred stock, if a company fails to make a dividend payment to preferred shareholders in a given year, it can pay no common dividends until preferred shareholders have been *paid in full for both current and missed dividends*. Anyone holding convertible preferred stock may exchange it for common stock. Thus, preferred shareholders can convert to common stock when and if the company's performance is strong—when its common stock is likely to go up in value.

Bonds

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Now, let's look at the second option: debt financing—raising capital through the sale of bonds. As with the sale of stock, the sale of bonds will increase your assets (again, specifically your cash) because you'll receive an inflow of cash (which, as we said, is good). But as we'll see, your *liabilities*—your debt to outside parties—will also increase (which is bad). And just as you'll need to find buyers for your stock, you'll need to find buyers for your bonds. Again, we need to ask the question: Why would anyone want to buy your company's bonds?

Your financial projections show that you need \$8 million to finance your expansion. If you decide to borrow this much money, you aren't likely to find one individual or institution that will loan it to you. But if you divided up the \$8 million loan into eight thousand smaller loans of \$1,000 each, you'd stand a better chance of getting the amount you need. That's the strategy behind issuing bonds: debt securities that obligate the issuer to make interest payments to bondholders (generally on a periodic basis) and to repay the principal when the bond matures. In other words, a bond is an IOU that pays interest. Like equity investors, bondholders can sell their securities on the financial market.

From the investor's standpoint, buying bonds is a way to earn a fairly good rate of return on money that he or she doesn't need for a while. The interest is better than what they'd get on a savings account or in a money market fund. But there is some risk. Investors who are interested in your bonds will assess the financial strength of your company: they want to feel confident that you'll be able to make your interest payments and pay back the principal when the time comes. They'll probably rely on data supplied by such bond-rating organizations as Moody's and Standard & Poor's, which rate bonds from AAA (highly unlikely to default) to D (in default).

Treasuries and Munis

Remember, too, that if you decide to issue bonds, you'll be competing with other borrowers, including state and local governments and the federal government. In fact, the U.S. government, which issues bonds through the Treasury Department, is the country's largest debtor. *Treasury bills*, for example, mature in one year, *Treasury notes* in one to ten years, and *Treasury bonds* in more than ten years. State and local governments issue bonds (often called *munis*, for "municipals") to support public services such as schools and

roads or special projects. Both treasuries and munis are attractive because the income earned on them is generally tax free at the state and local levels.

Choosing Your Financing Method

Let's say that after mulling over your money-raising options—equity financing versus debt financing—you decide to recommend to the board that the company issue common stock to finance its expansion. How do you explain your decision? Issuing bonds is an attractive option because it won't dilute your ownership, but you don't like the idea of repaying interest-bearing loans: at this point, you're reluctant to take on any future financial obligation, and money obtained through the sale of stock doesn't have to be paid back. Granted, adding additional shareholders will force you to relinquish some ownership interest: new shareholders will vote on your board of directors and could have some influence over major decisions. On balance, you prefer the option of selling stock—specifically, common stock. Why not preferred stock? Because it has drawbacks similar to those of debt financing: you'd have to make periodic dividend payments, requiring an outflow of cash. Once the matter has been settled, you take a well-deserved vacation. Unfortunately, you can't stop thinking about what you'll do the next time you want to expand. In particular, franchising seems to be a particularly attractive idea. It's something you'll need to research when you get a chance.

Key Takeaways

- Companies can raise funds through **equity financing** (selling stock) or through **debt financing** (issuing bonds).
- Stock may be **common stock** or **preferred stock**.
- Preferred stock is safer than common stock but it doesn't have the upside potential—namely, the possibility that shareholders will benefit greatly if a company performs very well.
- Unlike common stockholders, however, whose **dividends** vary according to a company's profitability, holders of preferred stock receive annual fixed dividends.

Chapter 13 Review Questions

Multiple Choice:

- Resistant to tearing is an example of _____ as a crucial property of money.
 1. Divisible
 2. Portable
 3. Durable
 4. Difficult to counterfeit
- 85% of money is deposited in _____.
 1. Commercial bank
 2. Finance company
 3. Brokerage firm
 4. Insurance company
- This is NOT one of the suggested ways to finance the business during the growth stage.
 1. Managing Bank Loan
 2. Managing Cash
 3. Managing Account Receivable
 4. Managing Accounts Payable
- The _____ is charged with enforcing securities laws.
 1. DOW
 2. NASDAQ
 3. SEC
 4. S&P 500
- This financing involves raising capital through debt financing.
 1. Common Stocks
 2. Preferred Stocks
 3. Bonds
 4. Treasury Bills

Short Answer:

1. Explain the three (3) basic functions of money.
2. Describe the three (3) tools the Fed uses to achieve its goals
3. Describe the difference between angels and venture capitalists.

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