Business Fundamentals

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Glossary

Detailed Licensing

Detailed Licensing

Licensing

A detailed breakdown of this resource's licensing can be found in ***Back Matter/Detailed Licensing****.*

CHAPTER OVERVIEW

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1.1: Understanding the External Factors that Influence Business

2. What are the sectors of the business environment, and how do changes in them influence business decisions?

Businesses do not operate in a vacuum but rather in a dynamic environment that has a direct influence on how they operate and whether they will achieve their objectives. This external business environment is composed of numerous outside organizations and forces that we can group into seven key subenvironments, as **Exhibit 1.4** illustrates: economic, political and legal, demographic, social, competitive, global, and technological. Each of these sectors creates a unique set of challenges and opportunities for businesses.

Business owners and managers have a great deal of control over the internal environment of business, which covers day-to-day decisions. They choose the supplies they purchase, which employees they hire, the products they sell, and where they sell those products. They use their skills and resources to create goods and services that will satisfy existing and prospective customers. However, the external environmental conditions that affect a business are generally beyond the control of management and change constantly. To compete successfully, business owners and managers must continuously study the environment and adapt their businesses accordingly.

Other forces, such as natural disasters, can also have a major impact on businesses. While still in the rebuilding stage after Hurricane Katrina hit in 2005, the U.S. Gulf Coast suffered another disaster in April 2010 as a result of an explosion on the Deepwater Horizon oil-rig, which killed 11 workers and sent more than 3 million barrels of oil into the Gulf of Mexico. This event, which played out for more than 87 days, severely affected the environment, businesses, tourism, and people's livelihoods. Global oil conglomerate BP, which was responsible for the oil spill, has spent more than $60 billion in response to the disaster and cleanup. Seven years after the explosion, tourism and other businesses are slowly recovering, although scientists are not certain about the long-term environmental consequences of the oil spill.[7]

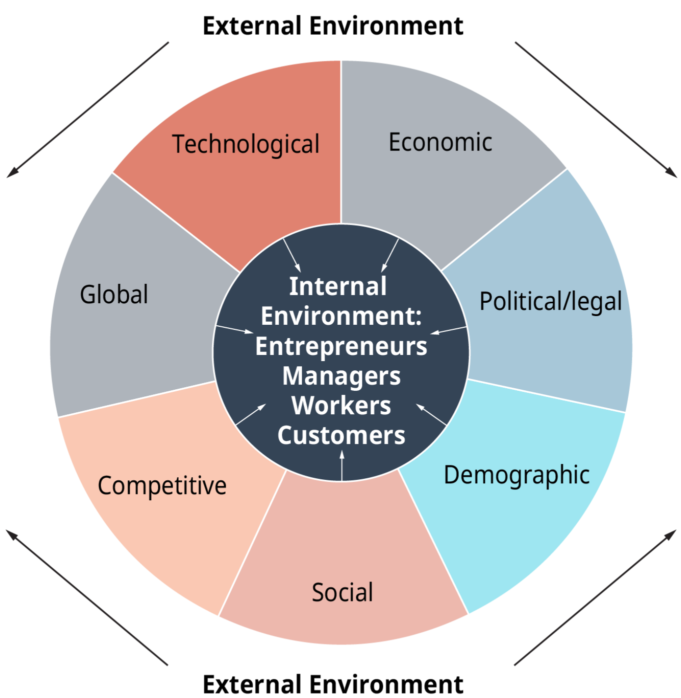

Exhibit 1.4: The Dynamic Business Environment (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

No one business is large or powerful enough to create major changes in the external environment. Thus, managers are primarily adapters to, rather than agents of, change. Global competition is basically an uncontrollable element in the external environment. In some situations, however, a firm can influence external events through its strategies. For example, major U.S. pharmaceutical companies have been successful in getting the Food and Drug Administration (FDA) to speed up the approval process for new drugs.[8]In recent years, the five largest companies in the S&P Index—Google, Facebook, Amazon, Microsoft, and Apple—have spent close to $50 million on lobbying activities in the nation's capital in an effort to help policy makers understand the tech industry and the importance of innovation and an “open” internet.[9] Let’s now take a brief look at these varied environmental influences.

Economic Influences

This category is one of the most important external influences on businesses. Fluctuations in the level of economic activity create business cycles that affect businesses and individuals in many ways. When the economy is growing, for example, unemployment rates are low, and income levels rise. Inflation and interest rates are other areas that change according to economic activity. Through the policies it sets, such as taxes and interest rate levels, a government attempts to stimulate or curtail the level of economic activity. In addition, the forces of supply and demand determine how prices and quantities of goods and services behave in a free market.

Political and Legal Influences

The political climate of a country is another critical factor for managers to consider in day-to-day business operations. The amount of government activity, the types of laws it passes, and the general political stability of a government are three components of political climate. For example, a multinational company such as General Electric will evaluate the political climate of a country before deciding to locate a plant there. Is the government stable, or might a coup disrupt the country? How restrictive are the regulations for foreign businesses, including foreign ownership of business property and taxation? Import tariffs, quotas, and export restrictions also must be taken into account.

In the United States, laws passed by Congress and the many regulatory agencies cover such areas as competition, minimum wages, environmental protection, worker safety, and copyrights and patents. For example, Congress passed the Telecommunications Act of 1996 to deregulate the telecommunications industry. As a result, competition increased and new opportunities arose as traditional boundaries between service providers blurred. Today the dramatic growth in mobile technology has changed the focus of telecommunications, which now faces challenges related to broadband access and speed, content streaming, and much-needed improvements in network infrastructure to address ever-increasing data transmissions.[10]

Federal agencies play a significant role in business operations. When Pfizer wants to bring a new medication for heart disease to market, it must follow the procedures set by the Food and Drug Administration for testing and clinical trials and secure FDA approval. Before issuing stock, Pfizer must register the securities with the Securities and Exchange Commission. The Federal Trade Commissionwill penalize Pfizer if its advertisements promoting the drug’s benefits are misleading. These are just a few ways the political and legal environment affect business decisions.

States and local governments also exert control over businesses—imposing taxes, issuing corporate charters and business licenses, setting zoning ordinances, and similar regulations. We discuss the legal environment in greater detail in a separate appendix.

Demographic Factors

Demographic factors are an uncontrollable factor in the business environment and extremely important to managers. **Demography** is the study of people’s vital statistics, such as their age, gender, race and ethnicity, and location. Demographics help companies define the markets for their products and also determine the size and composition of the workforce. You’ll encounter demographics as you continue your study of business.

Demographics are at the heart of many business decisions. Businesses today must deal with the unique shopping preferences of different generations, which each require marketing approaches and goods and services targeted to their needs. For example, the more than 75 million members of the millennial generation were born between 1981 and 1997. In 2017 they surpassed baby boomers as America’s largest generation.[11] The marketing impact of millennials continues to be immense. These are technologically savvy and prosperous young people, with hundreds of billions of dollars to spend. And spend they do—freely, even though they haven’t yet reached their peak income and spending years.[12] Other age groups, such as Generation X—people born between 1965 and 1980—and the baby boomers—born between 1946 and 1964—have their own spending patterns. Many boomers nearing retirement have money and are willing to spend it on their health, their comforts, leisure pursuits, and cars. As the population ages, businesses are offering more products that appeal to middle-aged and senior markets.[13]

In addition, minorities represent more than 38 percent of the total population, with immigration bringing millions of new residents to the country over the past several decades. By 2060 the U.S. Census Bureau projects the minority population to increase to 56 percent of the total U.S. population.[14] Companies recognize the value of hiring a diverse workforce that reflects our society.

Minorities’ buying power has increased significantly as well, and companies are developing products and marketing campaigns that target different ethnic groups.

Social Factors

Social factors—our attitudes, values, ethics, and lifestyles—influence what, how, where, and when people purchase products or services. They are difficult to predict, define, and measure because they can be very subjective. They also change as people move through different life stages. People of all ages have a broader range of interests, defying traditional consumer profiles. They also experience a “poverty of time” and seek ways to gain more control over their time. Changing roles have brought more women into the workforce. This development is increasing family incomes, heightening demand for time-saving goods and services, changing family shopping patterns, and impacting individuals’ ability to achieve a work-life balance. In addition, a renewed emphasis on ethical behavior within organizations at all levels of the company has managers and employees alike searching for the right approach when it comes to gender inequality, sexual harassment, and other social behaviors that impact the potential for a business’s continued success.

MANAGING CHANGE

Balancing Comes Easy at H&R Block

In an industry driven by deadlines and details, it’s hard to imagine striking a balance between work and everyday life for full-time employees and seasonal staff. Fortunately, the management team at H&R Block not only believes in maintaining a strong culture, it also tries to offer flexibility to its more than 70,000 employees and seasonal workers in 12,000 retail offices worldwide.

Based in Kansas City, Missouri, and built on a culture of providing exceptional customer service, H&R Block was recently named the top U.S. business with the best work-life balance by online job search site Indeed. Analyzing more than 10 million company reviews by employees, Indeed researchers identified the top 20 firms with the best work-life balance. H&R Blockheaded the 2017 list, followed by mortgage lender Network Capital Funding Corporation, fast food chain In-N-Out Burger, Texas food retailer H-E-B, and health services company Kaiser Permanente, among others.

According to Paul Wolfe, Indeed’s senior vice president of human resources, empathy on the part of organizations is a key factor in helping employees achieve balance. Wolfe says companies that demonstrate empathy and work diligently to provide personal time for all employees tend to take the top spots on the work-life balance list. “Comments we have seen from employee reviews for these companies indicate ‘fair’ and ‘flexible work environments,’” he says. Surprisingly, none of the tech companies known for their generous work perks made the top 20 list in 2017.

In this 24/7 world, when no one is far from a text or tweet, finding time for both family and work can be difficult, especially in the tax services industry, which is so schedule driven for a good part of the year. Making a commitment to help workers achieve a healthy work-life balance not only helps its employees, but it also helps H&R Block retain workers in a tight labor market where individuals continue to have choices when it comes to where and for whom they want to work.

Questions for Discussion

1. How does management’s support of employee work-life balance help the company’s bottom line?
2. What can other organizations learn from H&R Block when it comes to offering employee perks that encourage personal time for workers even during the busy tax season?

Sources: “Career Opportunities,” https://www.hrblock.com, accessed May 25, 2017; “About Us,” http://newsroom.hrblock.com, accessed May 25, 2017; Abigail Hess, “The 20 Best Companies for Work-Life Balance,” *CNBC*, http://www.cnbc.com, May 4, 2017; Kristen Bahler, “The 20 Best Companies for Work-Life Balance,” *Money*,http://time.com, April 20, 2017; Rachel Ritlop, “3 Benefits Companies Can Provide to Boost Work-Life Balance,” *Forbes*,http://www.forbes.com, January 30, 2017.

Technology

The application of technology can stimulate growth under capitalism or any other economic system. **Technology** is the application of science and engineering skills and knowledge to solve production and organizational problems. New equipment and software that improve productivity and reduce costs can be among a company’s most valuable assets. **Productivity** is the amount of goods and services one worker can produce. Our ability as a nation to maintain and build wealth depends in large part on the speed and effectiveness with which we use technology—to invent and adapt more efficient equipment to improve manufacturing productivity, to develop new products, and to process information and make it instantly available across the organization and to suppliers and customers.

Many U.S. businesses, large and small, use technology to create change, improve efficiencies, and streamline operations. For example, advances in cloud computing provide businesses with the ability to access and store data without running applications or programs housed on a physical computer or server in their offices. Such applications and programs can now be accessed through the internet. Mobile technology allows businesses to communicate with employees, customers, suppliers, and others at the swipe of a tablet or smartphone screen. Robots help businesses automate repetitive tasks that free up workers to focus on more knowledge-based tasks critical to business operations.[15]

CONCEPT CHECK

1. Define the components of the internal and the external business environments.
2. What factors within the economic environment affect businesses?
3. Why do demographic shifts and technological developments create both challenges and new opportunities for business?

1.2: Prelude - Why Is Apple Successful?

In 1976 Steve Jobs and Steve Wozniak created their first computer, the Apple I.[1] They invested a mere $1,300 and set up business in Jobs' garage. Three decades later, their business—Apple Inc.—has become one of the world's most influential and successful companies. Jobs and Wozniak were successful ***entrepreneurs****:* those who take the risks and reap the rewards associated with starting a new business enterprise. Did you ever wonder why Apple flourished while so many other young companies failed? How did it grow from a garage start-up to a company generating over $233 billion in sales in 2015? How was it able to transform itself from a nearly bankrupt firm to a multinational corporation with locations all around the world? You might conclude that it was the company's products, such as the Apple I and II, the Macintosh, or more recently its wildly popular iPod, iPhone, and iPad. Or, you could decide that it was its dedicated employees, management's wiliness to take calculated risks, or just plain luck – that Apple simply was in the right place at the right time.

Black and white photo of Steve Jobs wearing characteristic black turtleneck and pinching his chin between forefinger and thumb

Figure 2.1: Steve Jobs

Before we draw any conclusions about what made Apple what it is today and what will propel it into a successful future, you might like to learn more about Steve Jobs, the company's cofounder and former CEO. Jobs was instrumental in the original design of the Apple I and, after being ousted from his position with the company, returned to save the firm from destruction and lead it onto its current path. Growing up, Jobs had an interest in computers. He attended lectures at Hewlett-Packard after school and worked for the company during the summer months. He took a job at Atari after graduating from high school and saved his money to make a pilgrimage to India in search of spiritual enlightenment. Following his India trip, he attended Steve Wozniak's "Homebrew Computer Club" meetings, where the idea for building a personal computer surfaced.[2] "Many colleagues describe Jobs as a brilliant man who could be a great motivator and positively charming. At the same time his drive for perfection was so strong that employees who did not meet his demands [were] faced with blistering verbal attacks."[3] Not everyone at Apple appreciated Jobs' brilliance and ability to motivate. Nor did they all go along with his willingness to do whatever it took to produce an innovative, attractive, high-quality product. So at age thirty, Jobs found himself ousted from Apple by John Sculley, whom Jobs himself had hired as president of the company several years earlier. It seems that Sculley wanted to cut costs and thought it would be easier to do so without Jobs around. Jobs sold $20 million of his stock and went on a two-month vacation to figure out what he would do for the rest of his life. His solution: start a new personal computer company called NextStep. In 1993, he was invited back to Apple (a good thing, because neither his new company nor Apple was doing well).

Steve Jobs was definitely not known for humility, but he was a visionary and had a right to be proud of his accomplishments. Some have commented that "Apple's most successful days occurred with Steve Jobs at the helm."[4]

Jobs did what many successful CEOs and managers do: he learned, adjusted, and improvised.[5] Perhaps the most important statement that can be made about him is this: he never gave up on the company that once turned its back on him. So now you have the facts. Here's a multiple-choice question that you'll likely get right: Apple's success is due to (a) its products, (b) its customers, (c) luck, (d) its willingness to take risks, (e) Steve Jobs, or (f) some combination of these options.

1.3: Introduction to This Course

As the story of Apple suggests, today is an interesting time to study business. Advances in technology are bringing rapid changes in the ways we produce and deliver goods and services. The Internet and other improvements in communication (such as smartphones, video conferencing, and social networking) now affect the way we do business. Companies are expanding international operations, and the workforce is more diverse than ever. Corporations are being held responsible for the behavior of their executives, and more people share the opinion that companies should be good corporate citizens. Because of the role they played in the worst financial crisis since the Great Depression, businesses today face increasing scrutiny and negative public sentiment.[6]

Economic turmoil that began in the housing and mortgage industries as a result of troubled subprime mortgages quickly spread to the rest of the economy. In 2008, credit markets froze up and banks stopped making loans. Lawmakers tried to get money flowing again by passing a $700 billion Wall Street bailout, now-cautious banks became reluctant to extend credit. Without money or credit, consumer confidence in the economy dropped and consumers cut back on spending. Unemployment rose as troubled companies shed the most jobs in five years, and 760,000 Americans marched to the unemployment lines.[7] The stock market reacted to the financial crisis and its stock prices dropped by 44 percent while millions of Americans watched in shock as their savings and retirement accounts took a nose dive. In fall 2008, even Apple, a company that had enjoyed strong sales growth over the past five years, began to cut production of its popular iPhone. Without jobs or cash, consumers would no longer flock to Apple's fancy retail stores or buy a prized iPhone.[8] Since then, things have turned around for Apple, which continues to report blockbuster sales and profits. But not all companies or individuals are doing so well. The economy is still struggling, unemployment is high (particularly for those ages 16 to 24), and home prices have not fully rebounded from the crisis.

As you go through the course with the aid of this text, you'll explore the exciting world of business. We'll introduce you to the various activities in which business people engage—accounting, finance, information technology, management, marketing, and operations. We'll help you understand the roles that these activities play in an organization, and we'll show you how they work together. We hope that by exposing you to the things that businesspeople do, we'll help you decide whether business is right for you and, if so, what areas of business you'd like to study further.

1.4: Getting Down to Business

A business is any activity that provides goods or services to consumers for the purpose of making a profit. Be careful not to confuse the terms *revenue* and *profit*. **Revenue** represents the funds an enterprise receives in exchange for its goods or services. **Profit** is what's left (hopefully) after all the bills are paid. When Steve Jobs and Steve Wozniak launched the Apple I, they created Apple Computer in Jobs' family garage in the hope of making 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, Apple Watch), 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' 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.

Stakeholders

Consider your favorite restaurant. It may be an outlet or franchise of a national chain (more on franchises in a later chapter) or a local "mom and pop" without affiliation to a larger entity. Whether national or local, every business has **stakeholders** – those with a legitimate interest in the success or failure of the business and the policies it adopts. Stakeholders include customers, vendors, employees, landlords, bankers, and others (Figure 1.4.1). All have a keen interest in how the business operates, in most cases for obvious reasons. If the business fails, employees will need new jobs, vendors will need new customers, and banks may have to write off loans they made to the business. Stakeholders do not always see things the same way – their interests sometimes conflict with each other. For example, lenders are more likely to appreciate high profit margins that ensure the loans they made will be repaid, while customers would probably appreciate the lowest possible prices. Pleasing stakeholders can be a real balancing act for any company.

Figure 1.4.1: Business Stakeholders

1.5: Functional Areas of Business

The activities needed to operate a business can be divided into a number of **functional areas**. Examples include: 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, leading, 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 and staff the organization with qualified employees and managers *lead* 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, etc. Others, such as hospitals, convert resources into *intangible* products — e.g., 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 (i.e. market research) and design 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 and timely financial information, which is provided by accountants. **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. Financial 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 investments should be made in plant and equipment? How much should be spent on research and development? Good financial management is particularly important when a company is first formed, because new business owners usually need to borrow money to get started.

1.6: 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, technological developments, public pressure to act as good corporate citizens, and other factors. Collectively, these forces constitute what is known as the "**macro environment**" – essentially the big picture world external to a company over which the business exerts very little if any control. Figure 2.3 "Business and Its Environment" sums up the relationship between a business and the outside forces that influence its activities. One industry that's clearly affected by all these factors is the fast-food industry. Companies such as Taco Bell, McDonald's, Cook-Out and others all compete in this industry. A strong **economy** means people have more money to eat out. Food standards are monitored by a **government** agency, the Food and Drug Administration. Preferences for certain types of foods are influenced by **consumer trends** (fast food companies are being pressured to make their menus healthier). 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.[9]

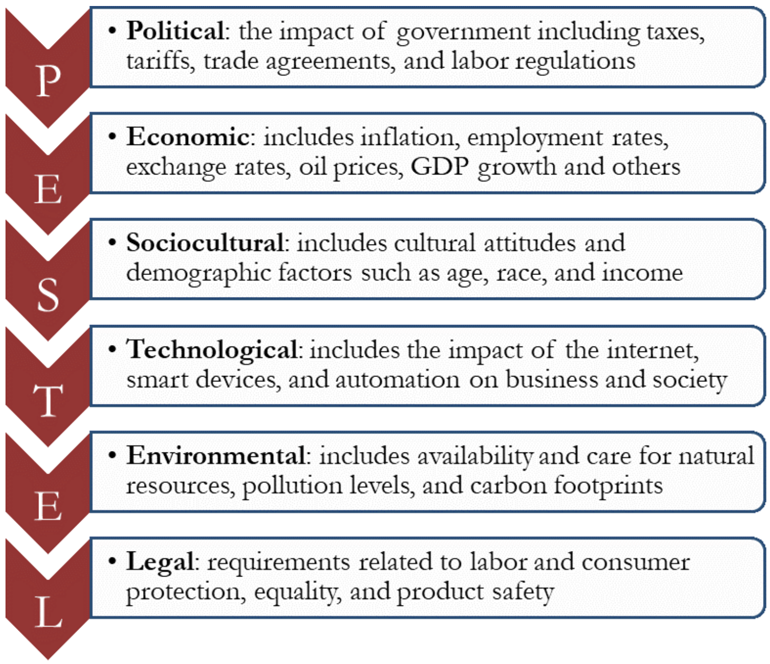

Figure 2.3: Business and its Environment – PESTEL

Of course, all industries are impacted by external factors, not just the food industry. As people have become more conscious of the environment, they have begun to choose new **technologies**, like all-electric cars to replace those that burn fossil fuels. Both established companies, like Nissan with its Nissan Leaf, and brand new companies like Tesla have entered the market for all-electric vehicles. While the market is still small, it is expected to grow at a compound annual growth rate of 19.2% between 2013 and 2019.[10]

PESTEL Analysis

One useful tool for analyzing the external environment in which an industry or company operates is the *PESTEL* model. PESTEL is an acronym, with each of the letters representing an aspect of the macro-environment that a business needs to consider in its planning. Let's briefly run through the meaning of each letter.

> P stands for the political environment. Governments influence the environment in which businesses operate in many ways, including taxation, tariffs, trade agreements, labor regulations, and environmental regulations.
>
> E represents the economic environment. As we will see in detail in a later chapter, whether the economy is growing or not is a major concern to business. Numerous economic indicators have been created for the specific purpose of measuring the health of the economy.
>
> S indicates the sociocultural environment, which is a category that captures societal attitudes, trends in national demographics, and even fashion trends. The term *demographics* applies to any attribute that can be used to describe people,

such as age, income level, gender, race, and so on. As a society's attitudes or its demographics change, the market for goods and services can shift right along with it.

T is for technological factors. In the last several decades, perhaps no force has impacted business more than the emergence of the internet. Nearly instantaneous access to information, e-commerce, social media, and even the ability to control physical devices from remote locations have all come about due to technological forces.

The second E stands for environmental forces, which in this case means natural resources, pollution levels, recycling, etc. While the attitudes of a society towards the natural environment would be considered a sociocultural force, the level of pollution, the supply of oil, etc. would be grouped under this second E for environment.

Finally the L represents legal factors. These forces often coincide with the political factors already discussed, because it is politicians (i.e., government) that enacts laws. However, there are other legal factors that can impact businesses as well, such as decisions made by courts that may have broad implications beyond the case being decided.

When conducting PESTEL analysis, it is important to remember that there can be considerable overlap from category to category. It's more important that businesses use the model to thoroughly assess its external environment, and much less important that they get all the forces covered under the "right" category. It is also important to remember that an individual force, in itself, is not inherently positive or negative but rather presents either an opportunity or a threat to different businesses. For example, societal attitudes moving in favor of green energy are an opportunity for those with capabilities in wind, solar, and other renewables, while presenting a threat, or at least a need to change, to companies whose business models depend exclusively on fossil fuels.

Video 1.6.1: This video covers the six macro environmental forces that make up the PESTEL model. Alyssa Duong. "The PESTEL Model" (VTech Works). February 16th, 2019. Retrieved from: https://vtechworks.lib.vt.edu/handle/10919/88014

1.7: Goals of Business

Learning Objective

Differentiate among potential goals of a business.

Key Points:

- Economic value added suggests that a principal challenge for a business is balancing the interests of parties affected by the business, interests that are sometimes in conflict with one another.
- Alternate definitions state that a business' principal purpose is to serve the interests of a larger group of stakeholders, including employees, customers, and even society as a whole.
- Many observers hold that concepts such as economic value added are useful in balancing profit-making objectives with other ends.
- Social progress is an emerging theme for businesses. It is integral for businesses to maintain high levels of social responsibility.

Definitions of Key Terms

Stakeholder: A person or organization with a legitimate interest in a given situation, action, or enterprise.

Corporation: A group of individuals, created by law or under authority of law, having a continuous existence independent of the existences of its members, and powers and liabilities distinct from those of its members.

Corporate Social Responsibility (CSR): A company's sense of responsibility towards the community and environment (both ecological and social) in which it operates. Companies express this citizenship (1) through their waste and pollution reduction processes, (2) by contributing educational and social programs and (3) by earning adequate returns on the employed resources.

The Goals of a Business

Profit Maximization

According to economist Milton Friedman, the main purpose of a business is to maximize profits for its owners, and in the case of a publicly-traded company, the stockholders are its owners. Others contend that a business's principal purpose is to serve the interests of a larger group of stakeholders, including employees, customers, and even society as a whole. Philosophers often assert that businesses should abide by some legal and social regulations. Anu Aga, ex-chairperson of Thermax Limited, once said, "We survive by breathing but we can't say we live to breathe. Likewise, making money is very important for a business to survive, but money alone cannot be the reason for business to exist".

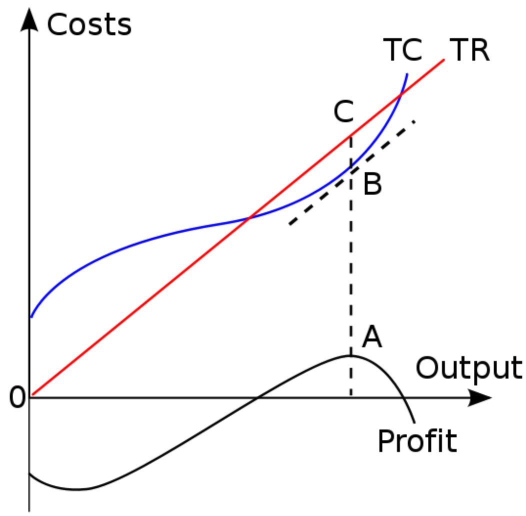

Figure 1.7.1: This chart depicts profit maximization using the totals approach, where TR = Total Revenue and TC = Total Cost. The profit-maximizing output level is represented as the one at which total revenue is the height of C and total cost is the height of B; the maximal profit is measured as CB. (Profit Maximization from What is a Business by Saylor, adapted from Boundless, CC BY-SA)

Social Benefit

Many observers would hold that concepts such as economic value added are useful in balancing profit-making objectives with other ends. They argue that sustainable financial returns are not possible without taking into account the aspirations and interests of other stakeholders such as customers, employees, society and the environment. This concept is called corporate social responsibility (CSR).

This conception suggests that a principal challenge for a business is to balance the interests of parties affected by the business, interests that are sometimes in conflict with one another. Former President Bill Clinton stated adamantly that major multinational companies must put their customers and employees' interests before those of shareholders in order to promote economic development and growth, especially in emerging markets. For example, Alibaba, a Chinese Internet venture, strives to operate in the zone that Clinton calls "double-bottom line capitalism". The emerging new mantra is to create social progress as well as create profits. In a sense, corporate social responsibility highlights the fact that business, consumers and society are part of a shared ecosystem, and that the long-term health of this ecosystem must be maintained above all else.

Innovation as a Goal

Rohit Kishore persuades that business can also be viewed to exist for the purpose of creative expansion. Successful firms like Google manage to align their activities towards the purpose of creative expansion from the perspective of all stakeholders, especially employees. This also validates the growing importance of innovation as a core principle for corporation survival and success.

Contract Theory

Advocates of business contract theory believe that a business is a community of participants organized around a common purpose. These participants have legitimate interests in how the business is conducted and, therefore, they have legitimate rights over its affairs. Most contract theorists see the enterprise being run by employees and managers as a kind of representative democracy.

Stakeholder Theory

Stakeholder theorists believe that people who have legitimate interests in a business also ought to have voice in how the business is run. However, stakeholder theorists take contract theory a step further, maintaining that people outside of the business enterprise ought to have a say in how the business operates. Thus, for example, consumers, even community members who could be affected by what the business does (for example, by the pollutants of a factory) ought to have some control over the business.

Business as Property

Some people believe that a business is essentially someone's property, and, as such, that its owners have the right to dispose of it as they see fit (within the confines of the law and morality). They do not believe that workers or consumers have special rights over the property, other than the right not to be harmed by its use without their consent. In this conception, workers voluntarily exchange their labor for wages from the business owner; they have no more right to tell the owner how he will dispose of his property than the owner has to tell them how to spend their wages. Similarly, assuming the business has purveyed its goods honestly and with full disclosure, consumers have no inherent rights to govern the business, which belongs to someone else.

People who subscribe to this view generally point out that a property owner's rights are constrained by morality. Thus, a homeowner cannot burn down his home and thereby jeopardize the entire neighborhood. Similarly, a business does not have an unlimited right to pollute the air in the manufacturing process.

Examples

- America has surpassed Europe in revenue growth over time. However, social responsibility may also have a critical role in business operations, so American revenue growth should not be solely considered in corporate success.
- Stakeholder theorists believe that people who have legitimate interests in a business should influence its operation. Consumers, and even community members who could be affected by what the business does, ought to have some voice in the decision making.
- Advocates of business contract theory believe that a business is a community of participants organized around a common purpose. Contract theorists see the enterprise being run by employees and managers as a kind of representative democracy.

1.8: End of Chapter Material

Key Takeaways

1. The main participants in a **business** are its **owners**, **employees**, and **customers**.
2. Every business must consider its **stakeholders**, and their sometimes conflicting interests, when making decisions.
3. The activities needed to run a business can be divided into **functional** The business functions correspond fairly closely to many majors found within a typical college of business.
4. Businesses are influenced by such **externalfactors** as the **economy**, **government**, and other forces external to the business. The PESTEL model is a useful tool for analyzing these forces.

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CHAPTER OVERVIEW

2: Entrepreneurs and Business

2.1: What Is an Entrepreneur
2.2: Entrepreneurial Mindset
2.3: Characteristics of an Entrepreneur

2.1: What Is an Entrepreneur

Learning Outcomes & Task Summary

Learning Outcomes:

- Define entrepreneurship
- Reflect on entrepreneurial themes
- Review approaches to entrepreneurship

Task Summary:

- Lesson 1.1.1: Defining Entrepreneurship
- Lesson 1.1.2: Entrepreneurial Themes
- Activity 1.1.1: Read/Watch/Listen
- Activity 1.1.2: Journal Entry

Begin this module by completing the lessons below. Many of the lessons in this course provide options to either watch or read the content in addition to working through brief lesson activities like multiple-choice questions to check your understanding. Work through each module in a linear fashion, beginning with the lessons and ending with the learning activities towards the bottom of the page.

Lesson 1.1.1: Defining Entrepreneurship

Transcript

What exactly is entrepreneurship and who comes to mind when you think of someone who is entrepreneurial? Is it someone who goes on Dragon's Den? Could it be the impassioned student who starts a non-profit to clean up the oceans? What about the uber eats driver who drops off tacos at your front door? There are a few common threads with all of these ideas and roles, some of which are believing in something or someone, having a passion for something awesome, and are committed to progress and making things happen. Would you want to have a life full of belief, passion, and progress? If so, you may be an entrepreneur!

Entrepreneurs are everywhere and they are a key part of our society. To start off, we will wrap our minds around, and define, the spirit of entrepreneurship. With our definition in mind, we will reflect on the role entrepreneurs have in our world, the different types of entrepreneurs, and their relevance.

While there may be some stereotypical views of who an entrepreneur is and what entrepreneurship is all about, the spirit of entrepreneurship is much broader than someone taking out a loan to start a business or going onto Dragon's Den to solicit investor funding. Entrepreneurs are everywhere, in all industries, facilitating changes to enhance the lives of themselves and others.

Let's have a look at and consider some quotes from some really smart people about what they have to say about entrepreneurship:

"Whilst there is no universally accepted definition of entrepreneurship, it is fair to say that it is multidimensional. It involves analyzing people and their actions together with the ways in which they interact with their environments, be these social, economic, or political, and the institutional, policy, and legal frameworks that help define and legitimize human activities". (Blackburn, 2011, p. xiii).

"Entrepreneurship involves such a range of activities and levels of analysis that no single definition is definitive" (Lichtenstein, 2011, p. 472).

"[Entrepreneurship] is complex, chaotic, and lacks any notion of linearity. As educators, we have the responsibility to develop our student's discovery reasoning and implementation skills so that they may excel in highly uncertain environments" (Neck and Greene, 2011, p. 55).

"An entrepreneur can be described as one who creates a new business in the face of risk and uncertainty for the purpose of achieving profit and growth by identifying significant opportunities and assembling the necessary resources to capitalize on them" (Zimmerer & Scarborough, 2008, p. 5).

"An entrepreneur is one who organizes manages and assumes the risk of a business or enterprise" (Entrepreneur, n.d.).

When trying to define entrepreneurship we might think of a person who undertakes the activities needed to start a business however given the diverse perspectives listed above that have nothing to do with starting a for-profit business it would seem that there is no hard and fast rule on the definition of entrepreneurship and it certainly isn't narrow enough to only reflect those activities completed to start a for-profit business.

Lesson 1.1.2: Entrepreneurial Themes

Transcript

After identifying about 90 attributes associated with entrepreneurship, Gartner (1990) went back to the entrepreneurs and other experts for help in clustering the attributes into themes that would help summarize what people concerned with entrepreneurship thought about the concept. He ended up with the following entrepreneurship themes:

The Entrepreneur

The entrepreneur theme is the idea that entrepreneurship involves individuals with unique personality characteristics and abilities (e.g., risk-taking, locus of control, autonomy, perseverance, commitment, vision, creativity). Almost 50% of the respondents rated these characteristics as not important to a definition of entrepreneurship (Gartner, 1990, p. 21, 24). The question that needs to be addressed is: "Does entrepreneurship involve entrepreneurs (individuals with unique characteristics)?" (Gartner, 1990, p. 25).

Innovation

The innovation theme is characterized as doing something new as an idea, product, service, market, or technology in a new or established organization. The innovation theme suggests that innovation is not limited to new ventures, but is recognized as something which older and/or larger organizations may undertake as well (Gartner, 1990, p. 25). Some of the experts Gartner questioned believed that it was important to include innovation in definitions of entrepreneurship and others did not think it was as important. (Gartner, 1990, p. 25).

Organization Creation

The organization creation theme describes the behaviors involved in creating organizations. This theme described acquiring and integrating resource attributes (e.g., Brings resources to bear, integrates opportunities with resources, mobilizes resources, gathers resources) and attributes that described creating organizations (new venture development and the creation of a business that adds value). (Gartner, 1990, p. 25). The question that needs to be addressed is: "Does entrepreneurship involve resource acquisition and integration (new venture creation activities)?" (Gartner, 1990, p. 25).

Creating Value

This theme articulated the idea that entrepreneurship creates value. The attributes in this factor indicated that value creation might be represented by improving an organization (this could be a business, a non-profit, a charity, or a small group changing the world), creating a new organization, growing an organization, creating wealth, or destroying the status quo. (Gartner, 1990, p. 25).

Uniqueness

This theme suggested that entrepreneurship must involve uniqueness. Uniqueness is characterized by attributes such as a special way of thinking, a vision of accomplishment, the ability to see situations in terms of unmet needs, and creates a unique combination. (Gartner, 1990, p. 26).

Entrepreneurship is many things to many people and it involves doing certain things, having certain skills and characteristics, as well as having access to resources that can (and should) be leveraged across all industries and types of organizations.

Entrepreneurial Approaches

One final way to look at entrepreneurship is through the approaches that are taken to improve one's life and the world around them. As a starting point, here are the four main approaches to entrepreneurship adapted from Gartner's attributes:

1. Innovate
    1. Definition: Innovation involves creatively solving problems and seeing solutions where they are not readily apparent.
2. Start a business
    1. Definition: Starting a business can be for something large or small and can involve many people or just one, The two things that makes starting a business unique from other types of organizations are they need to provide some kind of product or

service and the intent is to bring in more money then just covering costs (i.e. to profit).

3. Improve something from within
    1. Definition: Things are rarely perfect from the get-go, nor are they perfect as the world grows and changes! Making improvements within existing organizations to enhance efficiency and effectiveness can be not only valuable, but sometimes necessary for the well being of an organization!
4. Create of a non-profit organization
    1. Definition: non-profit organizations provide products and services, but the intent is to only charge enough money to cover the costs associated with that provision. Typically organizations like this provide some kind of social service and can be registered (or non-registered) non-profits, social enterprises, and charitable organizations

Keep these in mind as we will go into more detail on what these look like later on in the course and use these for your simulation work in Unit 3.

Activity 1.1.1: Read/Watch/Listen – Reflect

In Unit 2 we will learn about entrepreneurial skills, one of which is resource gathering. To get a head start on practicing your entrepreneurial resource gathering and innovation skills, your task is to search through the resources linked below to identify an entrepreneur who emulates the themes you have learned about and had success living out the definition of entrepreneurship you have started to craft throughout this module.

Reflect on the theme that appeals to you the most, and your draft definition of entrepreneurship, and reflect on how the theme and definition have both enabled the success of this individual, and how you might be able to create your own success using this theme and your definition as an entrepreneur over the next 18 months.

The key steps are:

1. Research the links below
2. Identify an entrepreneur from these resources you admire
3. Reflect on what entrepreneurial theme from Lesson 2 within which they have had success
4. Reflect on how their success relates to your own draft definition of entrepreneurship (does it change it? support it? why?)
5. Reflect on how you can create your own success using the theme and your definition of entrepreneurship over the next 18 months

Resources:

- Read this article on 9 Entrepreneurs Tell Their Stories of Pivoting 180 Degrees to Start New Careers
- Read this article on 30 Entrepreneurs who are Changing the World
- Read this article on Top 20 Most Famous Entrepreneurs in the World
- Watch this video on 50 Entrepreneurs Share Priceless Advice

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Activity 1.1.2: Journal Entry

See homepage note for reflective writing resources

So often when we go through learning, particularly in a formal educational setting, we get through the material as quickly as we can, and oftentimes don’t remember half of what was covered! Journaling can be a really powerful way to learn because it gets us to pause and reflect not only on what we have learned but also on what it means to us. Journaling makes meaning of material in a way that is personal and powerful.

It’s time to reflect on your Module 1 learning experience. . Part of being an entrepreneur requires a notable degree of self-reflection and self-awareness. This journal entry is all about the learning experience that you have had thus far. Identify your learning strengths, and what has come easily to you as you have gone through the first module of the course. Also, identify the areas which you want to strengthen and improve on from a learning perspective. Keep in mind this journal entry is not about the content you have learned, but rather how you have learned, and the Learning Experience. This is intended to help you better understand yourself as a learner, which is really important as you go through not only this course but also the rest of your education. Your journal entries should be either 300 to 500 written words or a video that is approximately 5 minutes.

Using your own experience and the course material, reflect in your journal (blog, vlog, etc) on all of the following prompts for this module:

- Key Concepts you have learned that help you better understand entrepreneurship
- Concepts that were easy to understand and why
    - If there was not a particular concept that was easy to understand, reflect on why this was the case
- Concepts that were difficult to understand and why
    - If there was not a particular concept that was difficult to understand, reflect on why this was the case

Next, create a rough draft definition of entrepreneurship (aim for one or two sentences).

Media Attributions

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Text Attributions

The quotes and parts of the opening paragraph sections are adapted from the "Entrepreneurship and Innovation Toolkit, 3rd Edition" by L. Swanson (2017) CC BY-SA

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2.2: Entrepreneurial Mindset

Learning Outcomes and Task Summary

Learning Outcomes:

- Discover the importance of entrepreneurial cognitions
- Assess whether entrepreneurial cognitions are defining features of successful entrepreneurs
- Consider which cognitive concepts provide the most insight into understanding entrepreneurs

Task Summary:

- Lesson 2.2.1: Entrepreneurial Cognitions
- Lesson 2.2.2: Bases of Entrepreneurial Cognition
- Activity 2.2.1: Read/Watch/Listen – Reflect
- Activity 2.2.2: Journal Entry

Lesson 2.2.1: Entrepreneurial Cognitions

Transcript

As amazing as entrepreneurship is, not everyone wants to be an entrepreneur. This may stem from the preconceived, and limited, notions of what an entrepreneur is, or taking on new things may feel overwhelming for some. For those who do choose to take on new adventures to drive positive change, not everyone is able to succeed in achieving their goals. Why is that? What is the distinguishing feature that makes some entrepreneurs successful while others are not?

Luckily some wise individuals have been studying this and have found that with all characteristics, traits, timing, access to resources, and luck being the same, the key factor that differentiates the entrepreneurs who are successful from those who are not, are entrepreneurial cognitions.

It is only fairly recently that entrepreneurship scholars have focused on cognitive skills as a primary factor that differentiates successful entrepreneurs from non-entrepreneurs and less successful entrepreneurs. This approach deals with how entrepreneurs think differently than non-entrepreneurs (Duening, 2010; Mitchell et al., 2007). Entrepreneurial cognitions are the knowledge structures that people use to make assessments, judgments, or decisions involving opportunity evaluation and venture creation and growth. In other words, research in entrepreneurial cognition is about understanding how entrepreneurs use simplifying mental models to piece together previously unconnected information that helps them to identify and invent new products or services, and to assemble the necessary resources to start and grow businesses (Mitchell, Busenitz, et al., 2002, p. 97).

Mitchell, Smith, et al. (2002) provided the example of how the decision to create a new venture (dependent variable) was influenced by three sets of cognitions (independent variables). They described these cognitions as follows:

Arrangements cognitions are the mental maps about the contacts, relationships, resources, and assets necessary to engage in entrepreneurial activity; willingness cognitions are the mental maps that support commitment to venturing and receptivity to the idea of starting a venture; ability cognitions consist of the knowledge structures or scripts (Glaser, 1984) that individuals have to support the capabilities, skills, norms, and attitudes required to create a venture (Mitchell et al., 2000).

According to Baron (2004a), by taking a cognitive perspective, we might better understand entrepreneurs and the role they play in the entrepreneurial process. The cognitive perspective emphasizes the fact that everything we think, say, or do is influenced by mental processes—the cognitive mechanisms through which we acquire store, transform, and use information. It is suggested here that this perspective can be highly useful to the field of entrepreneurship. Specifically, it can assist the field in answering three basic questions it has long addressed:

1. Why do some persons but not others choose to become entrepreneurs?
2. Why do some persons but not others recognize opportunities for new products or services that can be profitably exploited?
3. Why are some entrepreneurs so much more successful than others (Baron, 2004a, p. 221-222)?

Baron (2004a), illustrated how cognitive differences between people might explain why some people end up pursuing entrepreneurial pursuits and others do not. Research into cognitive biases might also help explain why some people become entrepreneurs.

Baron (2004a) also revealed ways in which cognitive concepts like signal detection theory, regulation theory, and entrepreneurship might help explain why some people are better at entrepreneurial opportunity recognition. He also illustrated how some cognitive models and theories – like risk perception, counterfactual thinking, processing
style, and susceptibility to cognitive errors – might help explain why some entrepreneurs are more successful than others.

Lesson 2.2.2: Bases of Entrepreneurial Cognition

Transcript

Prior Knowledge & Entrepreneurial Cognition

The ability to identify opportunities is among the most important skills successful entrepreneurs have (Ardichvili et al., 2003), thus making this topic particularly important for entrepreneurship research. While higher levels of knowledge (education) seem to facilitate opportunity recognition generally, different types of knowledge trigger the recognition of different types of opportunities (e.g., knowledge related to problems of nature can trigger the identification of environmental opportunities, and knowledge related to international markets can facilitate the identification of opportunities abroad). Knowledge related to opportunity recognition can be internal to the entrepreneur but can also be provided by external sources, such as venture capital investors.

Moreover, it appears that entrepreneurs' prior knowledge plays an important role in the cognitive process of structural alignment that "connects the known with the unknown" and, in doing so, can facilitate opportunity recognition.

Motivation and Entrepreneurial Cognition

In addition to prior knowledge, researchers have identified motivation—the behavior-triggering force, which directs behavior and increases persistence with a course of action (Bartol and Martin, 1998)—as an important antecedent of opportunity identification. Shepard and Patzelt found that while some motivators appear to trigger entrepreneurial action more generally (e.g., financial rewards or certain individual values), other types of motivation seem to stimulate a specific type of entrepreneurship (e.g., empathy motivating entrepreneurial action targeted toward developing societies). Interestingly, the inability to pursue a career as a salaried employee (e.g., due to injury or psychological disorder) can also stimulate entrepreneurial motivation. Finally, a key finding is that the effects of prior knowledge and those of motivation as described in this section do not seem to be independent of each other but can conjointly motivate entrepreneurial action.

Attention and Entrepreneurial Cognition

Attention refers to a non-specific and limited cognitive resource that is required for mental activities and differs across individuals and tasks
(Kahneman, 1973). While all of our attention is a limited resource, where we allocate attention influences several aspects of the entrepreneurial process, including environmental changes and the recognition, evaluation, and exploitation of opportunities. The research shows there are several factors at the individual, organizational, and environmental level that explain how entrepreneurs allocate attention, and that cognitive processes, particularly metacognition, impact individuals' attention allocation and thereby entrepreneurial outcomes.

Entrepreneurial Identity

Identity refers to the meanings that individuals attach to themselves (Gecas, 1982) and is often understood as the answer to the question "Who am I?" (Stryker and Burke, 2000). An entrepreneurial career provides multiple opportunities for individuals to develop a meaningful and unique self-identity that reflects the characteristics and traits discussed earlier in the course. To balance the fulfillment of the basic need to be distinct with the basic need to belong, entrepreneurs can apply integration or compartmentalization strategies to manage their work-related and non-work-related micro-identities. It is also important to note that traumatic events can disrupt one's occupational identity, and that entrepreneurship as an alternative career may help reconstruct it and in doing so help individuals recover emotionally and psychologically.

Emotion and Entrepreneurial Cognition

Entrepreneurship is a highly emotional endeavor; it has often been portrayed as an "emotional rollercoaster" with multiple ups and downs that impact
entrepreneurs' emotional experiences. Emotions not only play a key role in understanding entrepreneurs' opportunity exploitation decisions, but they also impact the motivation of employees to engage in entrepreneurial action. Particularly when entrepreneurial projects within organizations fail, employees often experience substantial negative emotions which can diminish motivation and learn from the failure experience. On the upside, these effects are contingent on the organizational environment normalizing failure, as well as individuals' coping orientations, self-efficacy, and self-compassion.

After completing the readings and videos, reflect on what these forms of cognition mean to you and how you have seen them manifest in your own life experience.

Activity 2.2.1: Read/Watch/Listen – Reflect

Continuing to build your entrepreneurial research, problem-solving, and opportunity identification skills, reflect on the entrepreneurial cognitions that appeal to you the most and reflect on how these cognitions, when paired with your definition of entrepreneurship, might be used to create your own entrepreneurial success over the next 18 months.

The key steps are:

1. Research the links below
2. Identify three entrepreneurial cognitions that seem particularly important to you
3. Reflect on why these cognitions are important and their role in entrepreneurial success
4. Reflect on your own abilities with these three specific cognitions
5. Reflect on how you can create your own success using these cognitions, given your definition of entrepreneurship over the next 18 months

Resources:

- Watch this video on the How Your Mind Can Amaze and Betray You
- Watch this video on Entrepreneurial Cognition
- Watch this video on How to Figure Out What You Really Want
- Watch this video on What is Success Playlist

Activity 2.2.2: Journal Entry

It's time to reflect on your Module 2 learning experience. This journal entry is all about the learning experience that you have had thus far. Identify your learning strengths, and what has come easily to you as you have gone through the first module of the course. Also, identify the areas which you want to strengthen and improve on from a learning perspective. Keep in mind this journal entry is not about the content you have learned, but rather how you have learned, and the Learning Experience. This is intended to help you better understand yourself as a learner, which is really important as you go through not only this course but also the rest of your education. You will reconsider your strengths, weaknesses, and key learnings and determine specific steps to prepare and complete the oncoming learning challenge of exploring the entrepreneurial mindset for yourself. Your journal entries should be either 150 to 300 written words or a video that is approximately 4 minutes.Using your own experience and the course material, reflect in your journal (blog, vlog, etc) on all of the following prompts for this module:

- Key Concepts you have learned that help you better understand entrepreneurship
- Concepts that were easy to understand and why
  - If there was not a particular concept that was easy to understand, reflect on why this was the case
- Concepts that were difficult to understand and why
  - If there was not a particular concept that was difficult to understand, reflect on why this was the case

Next, create a rough draft explanation of the entrepreneurial mindset (aim for one or two sentences).

Media Attributions

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- The content related to the bases of entrepreneurial cognition was taken from "Entrepreneurial Cognition: Exploring the Mindset of Entrepreneurs" by D. Shepard and H. Patzelt (2018) CC BY

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2.3: Characteristics of an Entrepreneur

Learning Outcomes and Task Summary

Learning Outcomes:

- Reflect on entrepreneurial uniqueness
- Assess the value of analyzing entrepreneurial traits
- Consider the importance of analyzing entrepreneurial skills and abilities
- Validate the importance of perseverance

Task Summary:

- Lesson 2.1.1: Entrepreneurial Uniqueness
- Lesson 2.1.2: Entrepreneurial Personality Traits
- Lesson 2.1.3: Beyond Personality Traits, Skills & Abilities
- Activity 2.1.1: Read/Watch/Listen
- Activity 2.1.2: Journal Entry

Lesson 2.1.1: Entrepreneurial Uniqueness

Transcript

So what makes an entrepreneur different from a preferences and abilities lens than someone who does not want to be an entrepreneur? What consistently makes these individuals unique? Do you yourself have what it takes to become an entrepreneur? Having a great concept is not enough. An entrepreneur must be able to develop and manage the company that implements his or her idea. Being an entrepreneur requires special drive, perseverance, passion, and a spirit of adventure, in addition to managerial and technical ability.

Entrepreneurs *are* the company; they tend to work longer hours, take fewer vacations, and cannot leave problems at the office at the end of the day. They also share other common characteristics, but what are these characteristics?

Historically, descriptions of entrepreneurial uniqueness have been based on personality, behavioral, and cognitive traits (Chell,  2008; Duening, 2010).

- Three personality characteristics of entrepreneurs that are often cited are:
  - Need for achievement
  - Internal locus of control (a belief by an individual that they are in control of their own destiny)
  - Risk-taking propensity

Past studies of personality characteristics and behavioral traits have not been overly successful at identifying entrepreneurial uniqueness. As it turned out, years of painstaking research along this line has not borne significant fruit. It appears that there are simply not any personality characteristics that are either essential to, or defining of, entrepreneurs that differ systematically from non-entrepreneurs…. Again, investigators proposed a number of behavioral candidates as emblematic of entrepreneurs. Unfortunately, this line of research also resulted in a series of dead ends as examples of successful entrepreneurial behaviors had equal counterparts among samples of non-entrepreneurs. As with the personality characteristic school of thought before it, the behavioral trait school of thought became increasingly difficult to support (Duening, 2010, p. 4-5).

This shed doubt on the value of trying to change personality characteristics or implant new entrepreneurial behaviors through educational programs in an effort to promote entrepreneurship. New research, however, has resurrected the idea that there might be some value in revisiting personality traits as a topic of study. Additionally, Duening (2010) and has suggested that an important approach to teaching and learning about entrepreneurship is to focus on the “cognitive skills that successful entrepreneurs seem uniquely to possess and deploy” (p. 2).

Lesson 2.1.2: Entrepreneurial Personality Traits

Transcript

While acknowledging that research had yet to validate the value of considering personality and behavior traits as ways to distinguish entrepreneurs from non-entrepreneurs or unsuccessful ones, Chell (2008) suggested that researchers turn their attention to new sets of traits including: “the proactive personality, entrepreneurial self-efficacy, perseverance, and intuitive decision-making. Other traits that require further work include social competence and the need for independence” (p. 140).

In more recent years scholars have considered how the Big Five personality traits – extraversion, agreeableness, conscientiousness, neuroticism (sometimes presented as emotional stability), and openness to experience (sometimes referred to as intellect) – might be used to better understand entrepreneurs. It appears that the Big Five traits might be of some use in predicting entrepreneurial success. Research is ongoing in this area, but in one example, Caliendo, Fossen, and Kritikos (2014) studied whether personality constructs might “influence entrepreneurial decisions at different points in time” (p. 807), and found that “high values in three factors of the Big Five approach—openness to experience, extraversion, and emotional stability (the latter only when we do not control for further personality characteristics)—increase the probability of entry into self-employment” (p. 807). They also found “that some specific personality characteristics, namely risk tolerance, locus of control, and trust, have strong partial effects on the entry decision” (p. 807). They also found that people who scored higher on agreeableness were more likely to exit their businesses, possibly meaning that people with lower agreeableness scores might prevail longer as entrepreneurs. When it came to specific personality traits, their conclusions indicated that those with an external locus of control were more likely to stop being self-employed after they had run their businesses for a while.

There are several implications for research like this, including the potential to better understand why some entrepreneurs behave as they do base upon their personality types and the chance to improve entrepreneurship education and support services.

Lesson 2.1.3: Beyond Personality Traits, Skills & Abilities

Transcript

A person with all the personality traits of an entrepreneur might still lack the necessary business skills to run a successful company. Entrepreneurs need the technical knowledge to carry out their ideas and the managerial ability to organize a company, develop operating strategies, obtain financing, and supervise day-to-day activities. Beyond basic business, good interpersonal and communication skills are important in dealing with employees, customers, and other business associates such as bankers, accountants, and attorneys. And then there’s perseverance.

When Jim Steiner started his toner cartridge remanufacturing business, Quality Imaging Products, his initial investment was $400. He spent $200 on a consultant to teach him the business and $200 on materials to rebuild his first printer cartridges. He made sales calls from 8.00 a.m. to noon and made deliveries to customers from noon until 5:00 p.m. After a quick dinner, he moved to the garage, where he filled copier cartridges until midnight, when he collapsed into bed, sometimes covered with carbon soot. And this was not something he did for a couple of weeks until he got the business off the ground—this was his life for 18 months (McFarland, 2005). This brief story is a great example of how perseverance is a key factor in entrepreneurial success.

Activity 2.1.1: Read/Watch/Listen

In Unit 3 we will start to embark on the entrepreneurial process. To prepare for this and continue practicing your entrepreneurial resource gathering and innovation skills, your task is to search through the resources linked below to identify an entrepreneur who emulates the characteristics you have learned about and had success living out the definition of entrepreneurship you have started to craft throughout this module.

Reflect on the characteristics that appeal to you the most, and reflect on how the characteristics and your definition of entrepreneurship from Unit 1 have both enabled the success of this individual, and how you might be able to create your own success developing these characteristics over the next 18 months.

The key steps are:

1. Research the links below
2. Identify an entrepreneur from these resources you admire
3. Reflect on what entrepreneurial theme from Lesson 2 within which they have had success
4. Reflect on how their success relates to your own draft definition of entrepreneurship (does it change it? support it? why?)
5. Reflect on how you can create your own success using the theme and your definition of entrepreneurship over the next 18 months

Resources:

- Read this article on Entrepreneurial Skills
- Read this article on Entrepreneurial Thinkers
- Read this article on Entrepreneurial Characteristics

Activity 2.1.2: Journal Entry

As a reminder, journaling can be a really powerful way to learn because it gets us to pause and reflect not only on what we have learned but also on what it means to us. Journaling makes meaning of material in a way that is personal and powerful.

It's time to reflect on your Unit 2, Module 1 learning experience. Part of being an entrepreneur requires a notable degree of self-reflection and self-awareness. This journal entry is all about the learning experience that you have had thus far. Identify your learning strengths, and what has come easily to you as you have gone through the first module of the course. Also, identify the areas which you want to strengthen and improve on from a learning perspective. Keep in mind this journal entry is not about the content you have learned, but rather how you have learned, and the Learning Experience. This is intended to help you better understand yourself as a learner, which is really important as you go through not only this course but also the rest of your education. Your journal entries should be either 150 to 300 written words or a video that is approximately 4 minutes.

Using your own experience and the course material, reflect in your journal (blog, vlog, etc) on all of the following prompts for this module:

- Key Concepts you have learned that help you better understand entrepreneurship
- Concepts that were easy to understand and why
  - If there was not a particular concept that was easy to understand, reflect on why this was the case
- Concepts that were difficult to understand and why
  - If there was not a particular concept that was difficult to understand, reflect on why this was the case

Next, note the key characteristics of successful entrepreneurs (aim for one or two sentences).

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CHAPTER OVERVIEW

3: Business and the Economy

3.1: Economic Systems and Business

3.2: The Nature of Business

3.3: Trends and Competition

3.1: Economic Systems and Business

3. What are the primary features of the world's economic systems, and how are the three sectors of the U.S. economy linked?

A business's success depends in part on the economic systems of the countries where it is located and where its sells its products. A nation's **economic system** is the combination of policies, laws, and choices made by its government to establish the systems that determine what goods and services are produced and how they are allocated. **Economics** is the study of how a society uses scarce resources to produce and distribute goods and services. The resources of a person, a firm, or a nation are limited. Hence, economics is the study of choices—what people, firms, or nations choose from among the available resources. Every economy is concerned with what types and amounts of goods and services should be produced, how they should be produced, and for whom. These decisions are made by the marketplace, the government, or both. In the United States, the government and the free-market system together guide the economy.

You probably know more about economics than you realize. Every day, many news stories deal with economic matters: a union wins wage increases at General Motors, the Federal Reserve Board lowers interest rates, Wall Street has a record day, the president proposes a cut in income taxes, consumer spending rises as the economy grows, or retail prices are on the rise, to mention just a few examples.

Global Economic Systems

Businesses and other organizations operate according to the *economic systems* of their home countries. Today the world's major economic systems fall into two broad categories: free market, or capitalism; and planned economies, which include communism and socialism. However, in reality many countries use a mixed market system that incorporates elements from more than one economic system.

The major differentiator among economic systems is whether the government or individuals decide:

- How to allocate limited resources—the factors of production—to individuals and organizations to best satisfy unlimited societal needs
- What goods and services to produce and in what quantities
- How and by whom these goods and services are produced
- How to distribute goods and services to consumers

Managers must understand and adapt to the economic system or systems in which they operate. Companies that do business internationally may discover that they must make changes in production and selling methods to accommodate the economic system of other countries. **Table 1.1** summarizes key factors of the world's economic systems.

Table 1.1: The Basic Economic Systems of the World

	Capitalism	Communism	Socialism	Mixed Economy
Ownership of Business	Businesses are privately owned with minimal government ownership or interference.	Government owns all or most enterprises.	Basic industries such as railroads and utilities are owned by government. Very high taxation as government redistributes income from successful private businesses and entrepreneurs.	Private ownership of land and businesses but government control of some enterprises. The private sector is typically large

	Capitalism	Communism	Socialism	Mixed Economy
Control of Markets	Complete freedom of trade. No or little government control.	Complete government control of markets.	Some markets are controlled, and some are free. Significant central-government planning. State enterprises are managed by bureaucrats. These enterprises are rarely profitable.	Some markets, such as nuclear energy and the post office, are controlled or highly regulated.
Worker Incentives	Strong incentive to work and innovate because profits are retained by owners.	No incentive to work hard or produce quality products.	Private-sector incentives are the same as capitalism, and public-sector incentives are the same as in a planned economy.	Private-sector incentives are the same as capitalism. Limited incentives in the public sector.
Management of Enterprises	Each enterprise is managed by owners or professional managers with little government interference.	Centralized management by the government bureaucracy. Little or no flexibility in decision-making at the factory level.	Significant government planning and regulation. Bureaucrats run government enterprises.	Private-sector management similar to capitalism. Public sector similar to socialism.
Forecast for 2020	Continued steady growth.	No growth and perhaps disappearance.	Stable with probable slight growth.	Continued growth.
Examples	United States	Cuba, North Korea	Finland, India, Israel	Great Britain, France, Sweden, Canada

Capitalism

In recent years, more countries have shifted toward free-market economic systems and away from planned economies. Sometimes, as was the case of the former East Germany, the transition to capitalism was painful but fairly quick. In other countries, such as Russia, the movement has been characterized by false starts and backsliding. **Capitalism**, also known as the *private enterprise system*, is based on competition in the marketplace and private ownership of the factors of production (resources). In a competitive economic system, a large number of people and businesses buy and sell products freely in the marketplace. In pure capitalism, all the factors of production are owned privately, and the government does not try to set prices or coordinate economic activity.

A capitalist system guarantees certain economic rights: the right to own property, the right to make a profit, the right to make free choices, and the right to compete. The right to own property is central to capitalism. The main incentive in this system is profit, which encourages entrepreneurship. Profit is also necessary for producing goods and services, building manufacturing plants, paying dividends and taxes, and creating jobs. The freedom to choose whether to become an entrepreneur or to work for someone else means that people have the right to decide what they want to do on the basis of their own drive, interest, and training. The government does not create job quotas for each industry or give people tests to determine what they will do.

Competition is good for both businesses and consumers in a capitalist system. It leads to better and more diverse products, keeps prices stable, and increases the efficiency of producers. Companies try to produce their goods and services at the lowest possible cost and sell them at the highest possible price. But when profits are high, more businesses enter the market to seek a share of those profits. The resulting competition among companies tends to lower prices. Companies must then find new ways of operating more efficiently if they are to keep making a profit—and stay in business.

Exhibit 1.5 McDonald's China Since joining the World Trade Organization in 2001, China has continued to embrace tenets of capitalism and grow its economy. China is the world's largest producer of mobile phones, PCs, and tablets, and the country's over one billion people constitute a gargantuan market. The explosion of McDonald's and KFC franchises epitomizes the success of American-style capitalism in China, and Beijing's bid to host the 2022 Winter Olympics is a symbol of economic openness. This McCafe is an example of changing Western products to suit Chinese tastes. This is an example of changing Western products to suit Chinese tastes. *Do you think China's capitalistic trend can continue to thrive under the ruling Chinese Communist Party that opposes workers' rights, free speech, and democracy?* (Credit: Marku Kudjerski/ flickr/ Attribution 2.0 Generic (CC BY 2.0)

Communism

The complete opposite of capitalism is **communism**. In a communist economic system, the government owns virtually all resources and controls all markets. Economic decision-making is centralized: the government, rather than the competitive forces in the marketplace, decides what will be produced, where it will be produced, how much will be produced, where the raw materials and supplies will come from, who will get the output, and what the prices will be. This form of centralized economic system offers little if any choice to a country's citizens. Early in the 20th century, countries that chose communism, such as the former Soviet Union and China, believed that it would raise their standard of living. In practice, however, the tight controls over most aspects of people's lives, such as what careers they can choose, where they can work, and what they can buy, led to lower productivity. Workers had no reasons to work harder or produce quality goods, because there were no rewards for excellence. Errors in planning and resource allocation led to shortages of even basic items.

These factors were among the reasons for the 1991 collapse of the Soviet Union into multiple independent nations. Recent reforms in Russia, China, and most of the eastern European nations have moved these economies toward more capitalistic, market-oriented systems. North Korea and Cuba are the best remaining examples of communist economic systems. Time will tell whether Cuba takes small steps toward a market economy now that the United States reestablished diplomatic relations with the island country a few years ago.[16]

Socialism

Socialism is an economic system in which the basic industries are owned by the government or by the private sector under strong government control. A socialist state controls critical, large-scale industries such as transportation, communications, and utilities. Smaller businesses and those considered less critical, such as retail, may be privately owned. To varying degrees, the state also determines the goals of businesses, the prices and selection of goods, and the rights of workers. Socialist countries typically provide their citizens with a higher level of services, such as health care and unemployment benefits, than do most capitalist countries. As a result, taxes and unemployment may also be higher in socialist countries. For example, in 2017, the top individual tax rate in France was 45 percent, compared to 39.6 percent in the United States. With both countries electing new presidents in 2017, tax cuts may be a campaign promise that both President Macron and President Trump take on as part of their overall economic agendas in the coming years.[17]

Many countries, including the United Kingdom, Denmark, India, and Israel, have socialist systems, but the systems vary from country to country. In Denmark, for example, most businesses are privately owned and operated, but two-thirds of the population is sustained by the state through government welfare programs.

Mixed Economic Systems

Pure capitalism and communism are extremes; real-world economies fall somewhere between the two. The U.S. economy leans toward pure capitalism, but it uses government policies to promote economic stability and growth. Also, through policies and laws, the government transfers money to the poor, the unemployed, and the elderly or disabled. American capitalism has produced some very powerful organizations in the form of large corporations, such as General Motors and Microsoft. To protect smaller firms and entrepreneurs, the government has passed legislation that requires that the giants compete fairly against weaker competitors.

Canada, Sweden, and the UK, among others, are also called **mixed economies**; that is, they use more than one economic system. Sometimes, the government is basically socialist and owns basic industries. In Canada, for example, the government owns the communications, transportation, and utilities industries, as well as some of the natural-resource industries. It also provides health care to its citizens. But most other activity is carried on by private enterprise, as in a capitalist system. In 2016, UK citizens voted for Britain to leave the European Union, a move that will take two or more years to finalize. It is too early to tell what impact the Brexit decision will have on the UK economy and other economies around the world.[18]

The few factors of production owned by the government in a mixed economy include some public lands, the postal service, and some water resources. But the government is extensively involved in the economic system through taxing, spending, and welfare activities. The economy is also mixed in the sense that the country tries to achieve many social goals—income redistribution and retirement pensions, for example—that may not be attempted in purely capitalist systems.

Macroeconomics and Microeconomics

The state of the economy affects both people and businesses. How you spend your money (or save it) is a personal economic decision. Whether you continue in school and whether you work part-time are also economic decisions. Every business also operates within the economy. Based on their economic expectations, businesses decide what products to produce, how to price them, how many people to employ, how much to pay these employees, how much to expand the business, and so on.

Economics has two main subareas. **Macroeconomics** is the study of the economy as a whole. It looks at *aggregate* data for large groups of people, companies, or products considered as a whole. In contrast, **microeconomics** focuses on individual parts of the economy, such as households or firms.

Both *macroeconomics* and *microeconomics* offer a valuable outlook on the economy. For example, Ford might use both to decide whether to introduce a new line of vehicles. The company would consider such macroeconomic factors as the national level of personal income, the unemployment rate, interest rates, fuel costs, and the national level of sales of new vehicles. From a microeconomic viewpoint, Ford would judge consumer demand for new vehicles versus the existing supply, competing models, labor and material costs and availability, and current prices and sales incentives.

Economics as a Circular Flow

Another way to see how the sectors of the economy interact is to examine the **circular flow** of inputs and outputs among households, businesses, and governments as shown in **Exhibit 1.6**. Let's review the exchanges by following the red circle around the inside of the diagram. Households provide inputs (natural resources, labor, capital, entrepreneurship, knowledge) to businesses, which convert these inputs into outputs (goods and services) for consumers. In return, households receive income from rent, wages, interest, and ownership profits (blue circle). Businesses receive revenue from consumer purchases of goods and services.

The other important exchange in **Exhibit 1.6** takes place between governments (federal, state, and local) and both households and businesses. Governments supply many types of publicly provided goods and services (highways, schools, police, courts, health services, unemployment insurance, social security) that benefit consumers and businesses. Government purchases from businesses also contribute to business revenues. When a construction firm repairs a local stretch of state highway, for example, government pays for the work. As the diagram shows, government receives taxes from households and businesses to complete the flow.

Changes in one flow affect the others. If government raises taxes, households have less to spend on goods and services. Lower consumer spending causes businesses to reduce production, and economic activity declines; unemployment may rise. In contrast, cutting taxes can stimulate economic activity. Keep the circular flow in mind as we continue our study of economics. The way economic sectors interact will become more evident as we explore macroeconomics and microeconomics.

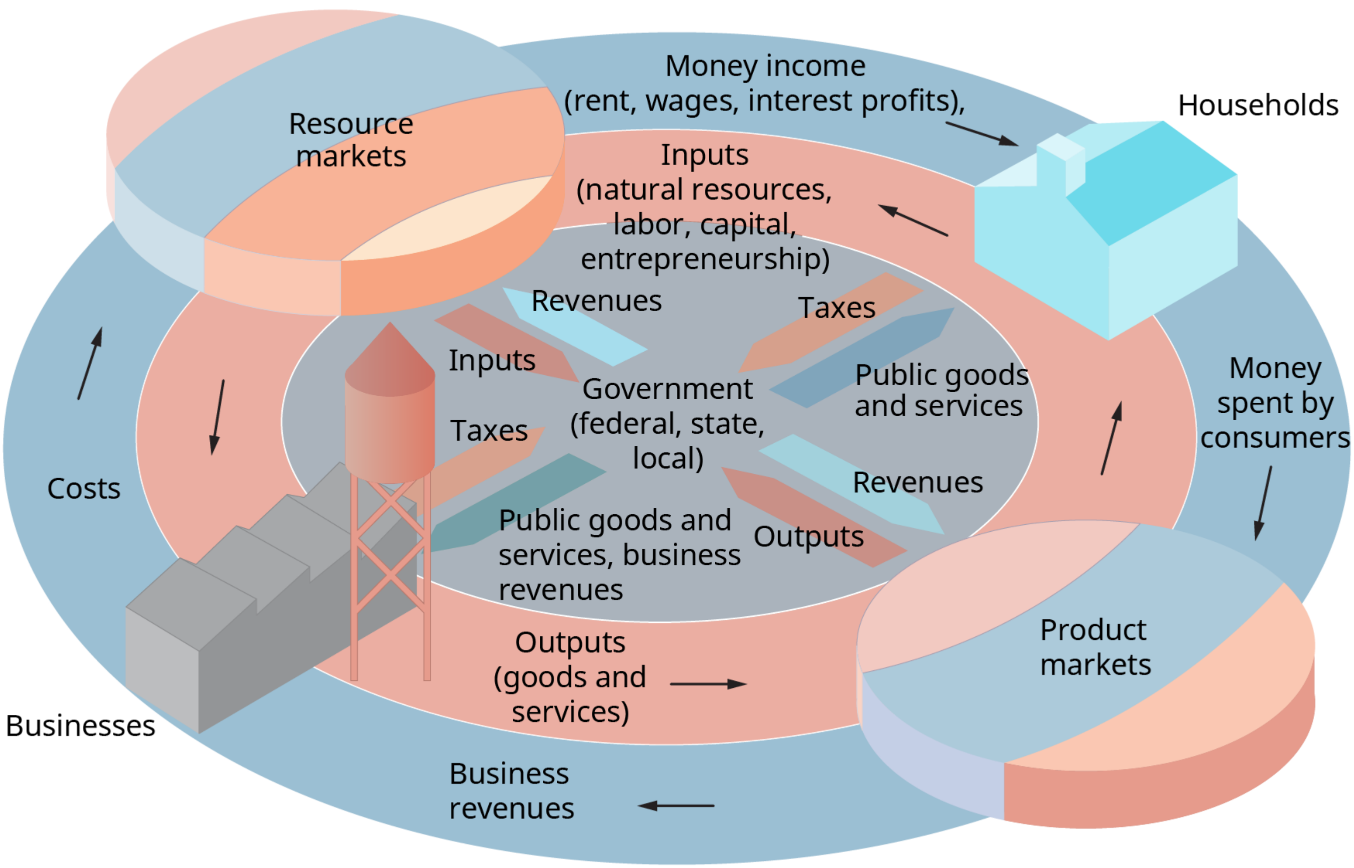

Exhibit 1.6 Economics as a Circular Flow (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

CONCEPT CHECK

1. What is economics, and how can you benefit from understanding basic economic concepts?
2. Compare and contrast the world's major economic systems. Why is capitalism growing, communism declining, and socialism still popular?
3. What is the difference between macroeconomics and microeconomics?

3.2: The Nature of Business

1. How do businesses and not-for-profit organizations help create our standard of living?

Take a moment to think about the many different types of businesses you come into contact with on a typical day. As you drive to class, you may stop at a gas station that is part of a major national oil company and grab lunch from a fast food chain such as Taco Bell or McDonald's or the neighborhood pizza place. Need more cash? You can do your banking on a smartphone or other device via mobile apps. You don't even have to visit the store anymore: online shopping brings the stores to you, offering everything from clothes to food, furniture, and concert tickets.

A **business** is an organization that strives for a profit by providing goods and services desired by its customers. Businesses meet the needs of consumers by providing medical care, autos, and countless other goods and services. **Goods** are tangible items manufactured by businesses, such as laptops. **Services** are intangible offerings of businesses that can't be held, touched, or stored. Physicians, lawyers, hairstylists, car washes, and airlines all provide services. Businesses also serve other organizations, such as hospitals, retailers, and governments, by providing machinery, goods for resale, computers, and thousands of other items.

Thus, businesses create the goods and services that are the basis of our standard of living. The **standard of living** of any country is measured by the output of goods and services people can buy with the money they have. The United States has one of the highest standards of living in the world. Although several countries, such as Switzerland and Germany, have higher average wages than the United States, their standards of living aren't higher, because prices are so much higher. As a result, the same amount of money buys less in those countries. For example, in the United States, we can buy an Extra Value Meal at McDonald's for less than $5, while in another country, a similar meal might cost as much as $10.

Businesses play a key role in determining our quality of life by providing jobs and goods and services to society. **Quality of life** refers to the general level of human happiness based on such things as life expectancy, educational standards, health, sanitation, and leisure time. Building a high quality of life is a combined effort of businesses, government, and not-for-profit organizations. In 2017, Vienna, Austria, ranked highest in quality of life, followed by Zurich, Switzerland; Auckland, New Zealand; and Munich, Germany. It may come as a surprise that not one of the world's top cities is in the United States: seven of the top 10 locations are in western Europe, two are in Australia/New Zealand, and one is in Canada. At the other end of the scale, Baghdad, Iraq, is the city scoring the lowest on the annual survey.[1] Creating a quality of life is not without risks, however. **Risk** is the potential to lose time and money or otherwise not be able to accomplish an organization's goals. Without enough blood donors, for example, the American Red Cross faces the risk of not meeting the demand for blood by victims of disaster. Businesses such as Microsoft face the risk of falling short of their revenue and profit goals. **Revenue** is the money a company receives by providing services or selling goods to customers. **Costs** are expenses for rent, salaries, supplies, transportation, and many other items that a company incurs from creating and selling goods and services. For example, some of the costs incurred by Microsoft in developing its software include expenses for salaries, facilities, and advertising. If Microsoft has money left over after it pays all costs, it has a **profit**. A company whose costs are greater than revenues shows a loss.

When a company such as Microsoft uses its resources intelligently, it can often increase sales, hold costs down, and earn a profit. Not all companies earn profits, but that is the risk of being in business. In U.S. business today, there is generally a direct relationship between risks and profit: the greater the risks, the greater the potential for profit (or loss). Companies that take too conservative a stance may lose out to more nimble competitors who react quickly to the changing business environment.

Take Sony, for example. The Japanese electronics giant, once a leader with its Walkman music player and Trinitron televisions, steadily lost ground—and profits—over the past two decades to other companies by not embracing new technologies such as the digital music format and flat-panel TV screens. Sony misjudged what the market wanted and stayed with proprietary technologies rather than create cross-platform options for consumers. Apple, at the time an upstart in personal music devices, quickly grabbed the lion's share of the digital music market with its iPods and iTunes music streaming service. By 2016, Sony restructured its business portfolio and has experienced substantial success with its PlayStation 4 gaming console and original gaming content.[2]

Not-for-Profit Organizations

Not all organizations strive to make a profit. A **not-for-profit organization** is an organization that exists to achieve some goal other than the usual business goal of profit. Charities such as Habitat for Humanity, the United Way, the American Cancer Society, and the World Wildlife Fund are not-for-profit organizations, as are most hospitals, zoos, arts organizations, civic groups, and religious organizations. Over the last 20 years, the number of nonprofit organizations—and the employees and volunteers who work for them—has increased considerably. Government is our largest and most pervasive not-for-profit group. In addition, more than 1.5 million nongovernmental not-for-profit entities operate in the United States today and contribute more than $900 billion annually to the U.S. economy.[3]

Like their for-profit counterparts, these groups set goals and require resources to meet those goals. However, their goals are not focused on profits. For example, a not-for-profit organization's goal might be feeding the poor, preserving the environment, increasing attendance at the ballet, or preventing drunk driving. Not-for-profit organizations do not compete directly with one another in the same manner as, for example, Ford and Honda, but they do compete for talented employees, people's limited volunteer time, and donations.

Exhibit 1.3: Rescue boat. Following Hurricane Irma affected The island of Puerto Rico, the Kentucky and Haraii National Guard assisted storm victims by donating to disaster relief efforts. Some not-for-profit charities focused aid toward the people of the region, but others delivered care to a different group of sufferers: animals and pets. Although most animal hospitals are not normally a refuge for displaced animals, many facilities opened their doors to pet owners affected by the torrential rains. *Why are tasks such as animal rescue managed primarily through not-for-profit organizations?* (Credit: Hawaii and Kentucky National Guard /flickr /Attribution 2.0 Generic (CC BY))

The boundaries that formerly separated not-for-profit and for-profit organizations have blurred, leading to a greater exchange of ideas between the sectors. As discussed in detail in the ethics chapter, for-profit businesses are now addressing social issues. Successful not-for-profits apply business principles to operate more effectively. Not-for-profit managers are concerned with the same concepts as their colleagues in for-profit companies: developing strategy, budgeting carefully, measuring performance, encouraging innovation, improving productivity, demonstrating accountability, and fostering an ethical workplace environment.

In addition to pursuing a museum's artistic goals, for example, top executives manage the administrative and business side of the organization: human resources, finance, and legal concerns. Ticket revenues cover a fraction of the museum's operating costs, so the director spends a great deal of time seeking major donations and memberships. Today's museum boards of directors include both art patrons and business executives who want to see sound fiscal decision-making in a not-for-profit setting. Therefore, a museum director must walk a fine line between the institution's artistic mission and financial policies. According to a survey by *The Economist*, over the next several years, major art museums will be looking for new directors, as more than a third of the current ones are approaching retirement.[4]

Factors of Production: The Building Blocks of Business

To provide goods and services, regardless of whether they operate in the for-profit or not-for-profit sector, organizations require inputs in the form of resources called **factors of production**. Four traditional factors of production are common to all productive activity: *natural resources*, *labor (human resources)*, *capital*, and *entrepreneurship*. Many experts now include *knowledge* as a fifth factor, acknowledging its key role in business success. By using the factors of production efficiently, a company can produce more goods and services with the same resources.

Commodities that are useful inputs in their natural state are known as natural resources. They include farmland, forests, mineral and oil deposits, and water. Sometimes natural resources are simply called land, although, as you can see, the term means more than just land. Companies use natural resources in different ways. International Paper Company uses wood pulp to make paper, and

Pacific Gas & Electric Company may use water, oil, or coal to produce electricity. Today urban sprawl, pollution, and limited resources have raised questions about resource use. Conservationists, environmentalists, and government bodies are proposing laws to require land-use planning and resource conservation.

Labor, or human resources, refers to the economic contributions of people working with their minds and muscles. This input includes the talents of everyone—from a restaurant cook to a nuclear physicist—who performs the many tasks of manufacturing and selling goods and services.

The tools, machinery, equipment, and buildings used to produce goods and services and get them to the consumer are known as **capital**. Sometimes the term *capital* is also used to mean the money that buys machinery, factories, and other production and distribution facilities. However, because money itself produces nothing, it is not one of the basic inputs. Instead, it is a means of acquiring the inputs. Therefore, in this context, capital does not include money.

Entrepreneurs are the people who combine the inputs of natural resources, labor, and capital to produce goods or services with the intention of making a profit or accomplishing a not-for-profit goal. These people make the decisions that set the course for their businesses; they create products and production processes or develop services. Because they are not guaranteed a profit in return for their time and effort, they must be risk-takers. Of course, if their companies succeed, the rewards may be great.

Today, many individuals want to start their own businesses. They are attracted by the opportunity to be their own boss and reap the financial rewards of a successful firm. Many start their first business from their dorm rooms, such as Mark Zuckerberg of Facebook, or while living at home, so their cost is almost zero. Entrepreneurs include people such as Microsoft cofounder Bill Gates, who was named the richest person in the world in 2017, as well as Google founders Sergey Brin and Larry Page.[5] Many thousands of individuals have started companies that, while remaining small, make a major contribution to the U.S. economy.

CATCHING THE ENTREPRENEURIAL SPIRIT

StickerGiant Embraces Change

Entrepreneurs typically are not afraid to take risks or change the way they do business if it means there is a better path to success. John Fischer of Longmont, Colorado, fits the profile.

The drawn-out U.S. presidential election in 2000 between Bush and Gore inspired Fischer to create a bumper sticker that claimed, “He’s Not My President,” which became a top seller. As a result of this venture, Fischer started an online retail sticker store, which he viewed as possibly the “Amazon of Stickers.” Designing and making stickers in his basement, Fischer’s start-up would eventually become a multimillion-dollar company, recognized in 2017 by *Forbes* as one of its top 25 small businesses.

The StickerGiant online store was successful, supplying everything from sports stickers to ones commemorating rock and roll bands and breweries. By 2011, the business was going strong; however, the entrepreneur decided to do away with the retail store, instead focusing the business on custom orders, which became StickerGiant’s main product.

As the company became more successful and added more employees, Fischer once again looked to make some changes. In 2012 he decided to introduce a concept called open-book management, in which he shares the company’s financials with employees at a weekly meeting. Other topics discussed at the meeting include customer comments and feedback, employee concerns, and colleague appreciation for one another. Fischer believes sharing information about the company’s performance (good or bad) not only allows employees to feel part of the operation, but also empowers them to embrace change or suggest ideas that could help the business expand and flourish.

Innovation is also visible in the technology StickerGiant uses to create miles and miles of custom stickers (nearly 800 miles of stickers in 2016). The manufacturing process involves digital printing and laser-finishing equipment. Fischer says only five other companies worldwide have the laser-finishing equipment StickerGiant uses as part of its operations. Because of the investment in this high-tech equipment, the company can make custom stickers in large quantities overnight and ship them to customers the next day.

This small business continues to evolve with an entrepreneur at the helm who is not afraid of making changes or having fun. In 2016, StickerGiant put together Saul the Sticker Ball, a *Guinness World Records* winner that weighed in at a whopping 232 pounds. Fischer and his employees created Saul when they collected more than 170,000 stickers that had been lying around the office and decided to put them to good use. With $10 million in annual sales and nearly 40 employees, StickerGiantcontinues to be a successful endeavor for John Fischer and his employees almost two decades after Fischer created his first sticker.

Questions for Discussion

1. How does being a risk-taker help Fischer in his business activities?
2. If you were a small business owner, would you consider sharing the company's financial data with employees? Explain your reasoning.

Sources: "All About StickerGiant," https://www.stickergiant.com, accessed May 29, 2017; Bo Burlingham, "Forbes Small Giants 2017: America's Best Small Companies," *Forbes*, http://www.forbes.com, May 9, 2017; Karsten Strauss, "Making Money and Breaking Records in the Sticker Business," *Forbes*, http://www.forbes.com, January 26, 2016; Emilie Rusch, "StickerGiant Does Big Business in Tiny Town of Hygiene," *Denver Post*, April 19, 2016, http://www.denverpost.com; Eric Peterson, "StickerGiant," *Company Week*, https://companyweek.com, September 5, 2016.

A number of outstanding managers and noted academics are beginning to emphasize a fifth factor of production—knowledge. **Knowledge** refers to the combined talents and skills of the workforce and has become a primary driver of economic growth. Today's competitive environment places a premium on knowledge and learning over physical resources. Recent statistics suggest that the number of U.S. **knowledge workers** has doubled over the last 30 years, with an estimated 2 million knowledge job openings annually. Despite the fact that many "routine" jobs have been replaced by automation over the last decade or outsourced to other countries, technology has actually created more jobs that require knowledge and cognitive skills.[6]

CONCEPT CHECK

1. Explain the concepts of revenue, costs, and profit.
2. What are the five factors of production?
3. What is the role of an entrepreneur in society?

3.3: Trends and Competition

8. Which trends are reshaping the business, microeconomic, and macroeconomic environments and competitive arena?

Trends in the business and economic environment occur in many areas. As noted earlier, today's workforce is more diverse than ever, with increasing numbers of minorities and older workers. Competition has intensified. Technology has accelerated the pace of work and the ease with which we communicate. Let's look at how companies are meeting the challenges of a changing workforce, the growing demand for energy, and how companies are meeting competitive challenges.

Changing Workforce Demographics

As the baby boomer generation ages, so does the U.S. workforce. In 2010, more than 25 percent of all employees were retirement age. Fast forward to the U.S. labor force in 2017, however, and millennials have taken over the top spot in the labor market, with more than 40 percent of the total workforce. Although older workers are now retiring closer to the traditional retirement age of 65, many plan to keep working beyond 65, often into their 70s. No longer is retirement an all-or-nothing proposition, and older workers in the baby boomer generation are taking a more positive attitude toward their later years. A surprising number of Americans expect to work full- or part-time after "retirement," and most would probably work longer if phased retirement programs were available at their companies. Financial reasons motivate most of these older workers, who worry that their longer life expectancies will mean outliving the money they saved for retirement, especially after retirement savings took a hit during the global recession of 2007–2009. For others, however, the satisfaction of working and feeling productive is more important than money alone.[29]

These converging dynamics continue to create several major challenges for companies today. And by 2020, additional generational shifts are projected to occur in the U.S. labor force, which will have an even bigger effect on how companies do business and retain their employees. Today's workforce spans five generations: recent college graduates (Generation Z); people in their 30s and 40s (millennials and Generation X); baby boomers; and traditionalists (people in their 70s). It is not unusual to find a worker who is 50, 60, or even 70 working for a manager who is not yet 30. People in their 50s and 60s offer their vast experience of "what's worked in the past," whereas those in their 20s and 30s tend to be experimental, open to options, and unafraid to take risks. The most effective managers will be the ones who recognize generational differences and use them to the company's advantage.[30]

Many companies have developed programs such as flexible hours and telecommuting to retain older workers and benefit from their practical knowledge and problem-solving skills. In addition, companies should continually track where employees are in their career life cycles, know when they are approaching retirement age or thinking about retirement, and determine how to replace them and their knowledge and job experiences.[31]

Another factor in the changing workforce is the importance of recognizing diversity among workers of all ages and fostering an inclusive organizational culture. According to a recent report by the U.S. Census Bureau, millennials are the largest generation in U.S. history, and more than 44 percent classify themselves as something other than "white." In addition, women continue to make progress on being promoted to management, although their path to CEO seems to be filled with obstacles. Recent statistics suggest that fewer than 5 percent of Fortune 500 companies have female CEOs. The most successful organizations will be the ones that recognize the importance of diversity and inclusion as part of their ongoing corporate strategies.[32]

MANAGING CHANGE

EY Makes Diversity and Inclusion a Top Priority

As older workers continue to leave the U.S. labor force and younger individuals begin work or move to other jobs to further their careers, businesses must recognize the importance of diversity and inclusion as key corporate strategies. This is particularly critical as multicultural millennials become the dominant group in the U.S. workforce. One leader in embracing diversity as an important part of corporate life is EY (formerly Ernst & Young), a global leader in assurance, tax, and advisory services.

EY believes its core values and business strategies are firmly based on diversity and inclusiveness, as evidenced by the company landing in the top spot of DiversityInc's 2017 list of the top companies for diversity. This recognition for EY is no accident; the company has made diversity and inclusion key goals for its more than 214,000 employees around the world. With a diverse workforce becoming the norm, it is no longer acceptable for companies to simply hold a random seminar or two for their managers and employees to discuss diversity and inclusion in the workplace.

Karyn Twaronite, EY's global diversity and inclusion officer, believes that a simple, ongoing approach is the most effective way to address diversity and inclusion in the workplace. The company uses a decision-making strategy called PTR, or preference, tradition, and requirement, to help managers think about diversity and inclusion. The strategy challenges managers to examine preferences toward job candidates who are similar to themselves, asks them whether their decision about hiring a specific candidate is influenced by traditional characteristics of a certain role, and urges them to make their selection based on the requirements of the job rather than on their personal preferences. In other words, the decision-making tool gives people a way to question the status quo without accusing colleagues of being biased.

Another way EY fosters inclusiveness is sponsoring professional network groups within the organization. These groups provide members with opportunities to network across various EY divisions, create informal mentoring relationships, and strengthen leadership skills. Some of the established networks within EY include groups for LGBT employees; blacks, Latinos, and pan-Asians; women; veterans; and employees with disabilities.

As a global company that works with clients in many countries, EY knows the importance of acknowledging different perspectives and cultures as part of its daily business. The company is committed to making sure employees as well as clients respect different viewpoints and individual differences, including background, education, gender, ethnicity, religious background, sexual orientation, ability, and technical skills. According to EY's diversity web page, research shows that a company's diverse teams are more likely to improve market share and have success in new markets and that they demonstrate stronger collaboration and better retention.

Questions for Discussion

1. How does EY's approach to diversity and inclusion translate to additional revenues for the company?
2. Would a company's commitment to diversity make a difference to you when interviewing for a job? Why or why not?

Sources: Company website, "A Diverse and Inclusive Workforce," http://www.ey.com, accessed May 29, 2017; "DiversityInc Top 50: #1—EY: Why They're on the List," http://www.diversityinc.com, accessed May 29, 2017; "Founded on Inclusiveness; Strengthened by Diversity: A Place for Everyone," exceptionaley.com, accessed May 29, 2017; Grace Donnelly, "Here's EY's Simple But Effective Strategy for Increasing Diversity," *Fortune,* http://fortune.com, February 10, 2017.

Global Energy Demands

As standards of living improve worldwide, the demand for energy continues to rise. Emerging economies such as China and India need energy to grow. Their demands are placing pressure on the world's supplies and affecting prices, as the laws of supply and demand would predict. For example, in recent years, China and India were responsible for more than half of the growth in oil products consumption worldwide. State-supported energy companies in China, India, Russia, Saudi Arabia, and other countries will place additional competitive pressure on privately owned oil companies such as BP, Chevron, ExxonMobil, and Shell.[33]

Countries worldwide worry about relying too heavily on one source of supply for energy. The United States imports a large percentage of its oil from Canada and Saudi Arabia. Europeans get 39 percent of their natural gas from Russia's state-controlled gas utility OAO Gazprom.[34] This gives foreign governments the power to use energy as a political tool. For example, continuing tensions between Russia and Ukraine in November 2015 caused Russia to stop sending natural gas to Ukraine, which also causes gas disruptions in Europe because Russia uses Ukraine's pipelines to transport some of its gas deliveries to European countries. In 2017, Russia announced plans to build its own pipeline alongside Ukraine's gas line in the Baltic Sea, which would allow Russia to bypass Ukraine's pipelines altogether and deliver gas directly to European countries.[35]

Countries and companies worldwide are seeking additional sources of supply to prevent being held captive to one supplier. For example, the relatively new technology of extracting oil from shale rock formations in the United States (known as fracking) has help create an important resource for the country's oil industry. This innovative approach to finding new sources of energy now accounts for more than half of the country's oil output, which can help reduce U.S. dependence on foreign oil and create new jobs.[36]

Meeting Competitive Challenges

Companies are turning to many different strategies to remain competitive in the global marketplace. One of the most important is **relationship management**, which involves building, maintaining, and enhancing interactions with customers and other parties to develop long-term satisfaction through mutually beneficial partnerships. Relationship management includes both *supply chain management*, which builds strong bonds with suppliers, and *relationship marketing*, which focuses on customers. In general, the longer a customer stays with a company, the more that customer is worth. Long-term customers buy more, take less of a company's time, are less sensitive to price, and bring in new customers. Best of all, they require no acquisition or start-up costs. Good long-standing customers are worth so much that in some industries, reducing customer defections by as little as five points—from, say, 15 percent to 10 percent per year—can double profits.

Another important way companies stay competitive is through **strategic alliances** (also called *strategic partnerships*). The trend toward forming these cooperative agreements between business firms is accelerating rapidly, particularly among high-tech firms. These companies have realized that strategic partnerships are more than just important—they are critical. Strategic alliances can take many forms. Some companies enter into strategic alliances with their suppliers, who take over much of their actual production and manufacturing. For example, Nike, the largest producer of athletic footwear in the world, does not manufacture a single shoe.

Other companies with complementary strengths team up. For example, Harry's Shave Club, an online men's grooming subscription service, recently teamed up with retail giant Target to improve sales and boost its brand presence among Target shoppers. Harry's products are now available in Target's brick-and-mortar stores and on Target's website as part of an exclusive deal that makes Targetthe only mass retailer to carry Harry's grooming products. The men's shaving industry accounts for more than $2.6 billion in annual sales.[37]

CONCEPT CHECK

1. What steps can companies take to benefit from the aging of their workers and to effectively manage a multigenerational workforce?
2. Why is the increasing demand for energy worldwide a cause for concern?
3. Describe several strategies that companies can use to remain competitive in the global economy.

CHAPTER OVERVIEW

4: Forms of Business Ownership

4.1: Types of Business Ownership

4.1: Types of Business Ownership

Learning Objectives

1. Identify the questions to ask in choosing the appropriate form of ownership for a business.
2. Describe the sole proprietorship and partnership forms of organization, and specify the advantages and disadvantages.
3. Identify the different types of partnerships, and explain the importance of a partnership agreement.
4. Explain how corporations are formed and how they operate.
5. Discuss the advantages and disadvantages of the corporate form of ownership.
6. Examine special types of business ownership, including limited-liability companies, and not-for-profit corporations.
7. Define mergers and acquisitions, and explain why companies are motivated to merge or acquire other companies.

The Ice Cream Men

Who would have thought it? Two ex-hippies with strong interests in social activism would end up starting one of the best-known ice cream companies in the country—Ben & Jerry's. Perhaps it was meant to be. Ben Cohen (the "Ben" of Ben & Jerry's) always had a fascination with ice cream. As a child, he made his own mixtures by smashing his favorite cookies and candies into his ice cream. But it wasn't until his senior year in high school that he became an official "ice cream man," happily driving his truck through neighborhoods filled with kids eager to buy his ice cream pops. After high school, Ben tried college but it wasn't for him. He attended Colgate University for a year and a half before he dropped out to return to his real love: being an ice cream man. He tried college again—this time at Skidmore, where he studied pottery and jewelry making—but, in spite of his selection of courses, still didn't like it.

Figure 6.1: Ben Cohen and Jerry Greenfield in 2010

In the meantime, Jerry Greenfield (the "Jerry" of Ben & Jerry's) was following a similar path. He majored in pre-med at Oberlin College in the hopes of one day becoming a doctor. But he had to give up on this goal when he was not accepted into medical school. On a positive note, though, his college education steered him into a more lucrative field: the world of ice cream making. He got his first peek at the ice cream industry when he worked as a scooper in the student cafeteria at Oberlin. So, fourteen years after they first met on the junior high school track team, Ben and Jerry reunited and decided to go into ice cream making big time. They moved to Burlington, Vermont—a college town in need of an ice cream parlor—and completed a $5 correspondence course from Penn State on making ice cream. After getting an A in the course—not surprising, given that the tests were open book—they took the plunge: with their life savings of $8,000 and $4,000 of borrowed funds they set up an ice cream shop in a made-over gas station on a busy street corner in Burlington.[1] The next big decision was which form of business ownership was best for them. This chapter introduces you to their options.

Factors to Consider

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, let's address some of the questions that you'd probably ask yourself in choosing the appropriate legal form for your business.

1. In setting up 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? How much responsibility for running the business are you willing to share? What about sharing the profits?
3. Do you want to avoid special taxes?
4. Do you have all the skills needed to run the business?

5. Are you likely to get along with your co-owners over an extended period of time?
6. Is it important to you that the business survive you?
7. What are your financing needs and how do you plan to finance your company?
8. How much personal exposure to liability are you willing to accept? 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 three ownership options (sole proprietorship, partnership, corporation) on these eight dimensions.

Sole Proprietorship and its Advantages

In a **sole proprietorship**, as the owner, you have complete control over your business. You make all important decisions and are 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.

Disadvantages of Sole Proprietorships

For many people, however, the sole proprietorship is not suitable. The flip side of enjoying complete control is having to supply all the different talents that may be necessary to make the business a success. And when you're gone, 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. The principle of unlimited personal liability means that if the business 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.

Partnership

A **partnership** (or general partnership) is a business owned jointly by two or more people. About 10 percent of U.S. businesses are partnerships[2] 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

A major problem with partnerships, as with sole proprietorships, is **unlimited liability**: in this case, each partner is personally liable not only for his or her own actions but also for the actions of all the partners. If your partner in an architectural firm makes a mistake that causes a structure to collapse, the loss your business incurs impacts you just as much as it would him or her. 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, the party who suffered a loss because of the error can sue you for your personal assets. Many people are understandably reluctant to enter into partnerships because of unlimited liability. Certain forms of businesses allow owners to limit their liability. These include limited partnerships and corporations**.**

Limited Partnerships

The law permits business owners to form 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 jeopardizing 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.

Corporation

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. Once businesses reach any substantial size, it is advantageous to organize as a corporation so that its owners can limit their liability. Corporations, then, tend to be far larger, on average, than businesses using other forms of ownership. As Figure 6.2 shows, corporations account for 18 percent of all U.S. businesses but generate almost 82 percent of the revenues.[3] Most large well-known businesses are corporations, but so are many of the smaller firms with which likely you do business.

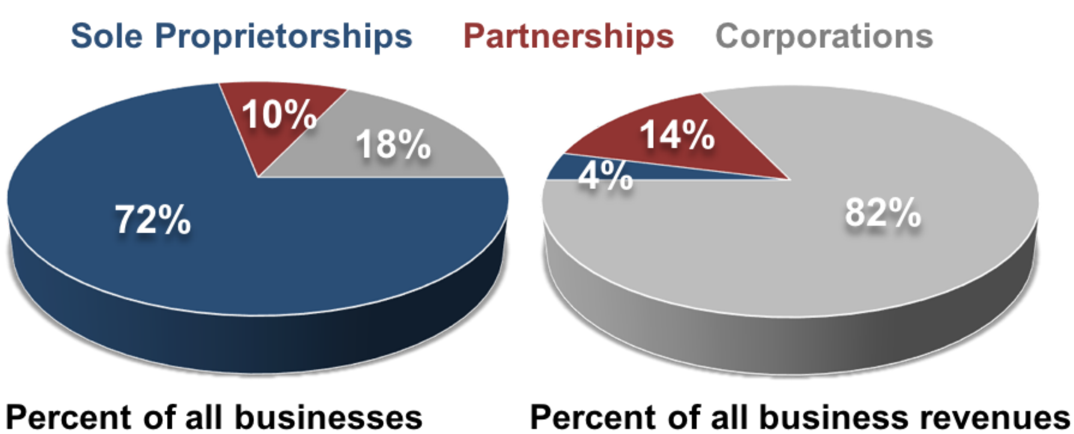

Figure 6.2: Types of U.S. Businesses

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. 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. 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 aspects. 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, are often more interested in career advancement than the overall profitability of the company. Stockholders might care more about profits without regard for the well-being of employees. This situation is known as the **agency problem**, a conflict of interest inherent in a relationship in which one party is supposed to act in the best interest of the other. It is often quite difficult to prevent self-interest from entering into these situations.

Another drawback to incorporation—one that often discourages small businesses from incorporating—is the fact that corporations are more 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.[4] 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."[5] 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.[6] Eventually, as the company continued to expand, the stock was sold on a national level.

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Other Types of Business Ownership

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 two of these options:

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

Limited-Liability Companies

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? The **limited-liability company(LLC)** accomplishes exactly that. This form provides business owners with limited liability (a key advantage of corporations) and no "double taxation" (a key advantage of sole proprietorships and partnerships). Let's look at the LLC in more detail.

In 1977, Wyoming became the first state to allow businesses to operate as limited-liability companies. Twenty years later, in 1997, Hawaii became 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 a limited-liability company, 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).

We have touted the benefits of limited liability protection for an LLC. We now need to point out some circumstances under which an LLC member (or a 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:

- Personally guarantees a business debt or bank loan which the company fails to pay.
- Fails to pay employment taxes to the government.
- Engages in fraudulent or illegal behavior that harms the company or someone else.
- Does not treat the company as a separate legal entity, for example, uses company assets for personal uses.

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 can 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; universities; and conservation groups.

There are more than 1.5 million not-for-profit organizations in the United States.[7] Some are extremely well funded, such as the Bill and Melinda Gates Foundation, which has an endowment of approximately $40 billion and has given away $36.7 billion since its inception.[8] 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.

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Mergers and Acquisitions

The headline read, "Wanted: More than 2,000 in Google Hiring Spree."[9] The largest Web search engine in the world was disclosing its plans to grow internally and increase its workforce by more than 2,000 people, with half of the hires coming from the United States and the other half coming from other countries. The added employees will help the company expand into new markets and battle for global talent in the competitive Internet information providers industry. When properly executed, internal growth benefits the firm.

An alternative approach to growth is to merge with or acquire another company. The rationale behind growth through merger or acquisition is that 1 + 1 = 3: the combined company is more valuable than the sum of the two separate companies. This rationale is attractive to companies facing competitive pressures. To grab a bigger share of the market and improve profitability, companies will want to become more cost efficient by combining with other companies.

Mergers and Acquisitions

Though they are often used as if they're synonymous, the terms merger and acquisition mean slightly different things. A **merger** occurs when two companies combine to form a new company. An **acquisition** is the purchase of one company by another. An example of a merger is the merging in 2013 of US Airways and American Airlines. The combined company, the largest carrier in the world, flies under the name American Airlines.

Another example of an acquisition is the purchase of Reebok by Adidas for $3.8 billion.[10] The deal was expected to give Adidas a stronger presence in North America and help the company compete with rival Nike. Once this acquisition was completed, Reebok as a company ceased to exist, though Adidas still sells shoes under the Reebok brand.

Motives behind Mergers and Acquisitions

Companies are motivated to merge or acquire other companies for a number of reasons, including the following.

Gain Complementary Products

Acquiring **complementary products** was the motivation behind Adidas's acquisition of Reebok. As Adidas CEO Herbert Hainer stated in a conference call, "This is a once-in- a-lifetime opportunity. This is a perfect fit for both companies, because the companies are so complementary…. Adidas is grounded in sports performance with such products as a motorized running shoe and endorsement deals with such superstars as British soccer player David Beckham. Meanwhile, Reebok plays heavily to the melding of sports and entertainment with endorsement deals and products by Nelly, Jay-Z, and 50 Cent. The combination could be deadly to Nike." Of course, Nike has continued to thrive, but one can't blame Hainer for his optimism.[11]

Attain New Markets or Distribution Channels

Gaining new markets was a significant factor in the 2005 merger of US Airways and America West. US Airways was a major player on the East Coast, the Caribbean, and Europe, while America West was strong in the West. The expectations were that combining the two carriers would create an airline that could reach more markets than either carrier could do on its own.[12]

Realize Synergies

The purchase of Pharmacia Corporation (a Swedish pharmaceutical company) by Pfizer (a research-based pharmaceutical company based in the United States) in 2003 created one of the world's largest drug makers and pharmaceutical companies, by revenue, in every major market around the globe.[13] The acquisition created an industry giant with more than $48 billion in revenue and a research-and-development budget of more than $7 billion. Each day, almost forty million people around the globe are treated with Pfizer medicines.[14] Its subsequent $68 billion purchase of rival drug maker Wyeth further increased its presence in the pharmaceutical market.[15]

In pursuing these acquisitions, Pfizer likely identified many **synergies**: quite simply, a whole that is greater than the sum of its parts. There are many examples of synergies. A merger typically results in a number of redundant positions; the combined company does not likely need two vice-presidents of marketing, two chief financial officers, and so on. Eliminating the redundant positions leads to significant cost savings that would not be realized if the two companies did not merge. Let's say each of the companies was operating factories at 50% of capacity, and by merging, one factory could be closed and sold. That would also be an example of a synergy. Companies bring different strengths and weaknesses into the merged entity. If the newly-combined company can take advantage of the marketing capabilities of the stronger entity and the distribution capabilities of the other (assuming they are stronger), the new company can realize synergies in both of these functions.

Hostile Takeover

What happens, though, if one company wants to acquire another company, but that company doesn't want to be acquired? The outcome could be a **hostile takeover**—an act of assuming control that's resisted by the targeted company's management and its board of directors. Ben Cohen and Jerry Greenfield found themselves in one of these situations: Unilever—a very large Dutch/British company that owns three ice cream brands—wanted to buy Ben & Jerry's, against the founders' wishes. Most of the Ben & Jerry's stockholders sided with Unilever. They had little confidence in the ability of Ben Cohen and Jerry Greenfield to continue managing the company and were frustrated with the firm's social-mission focus. The stockholders liked Unilever's offer to buy their Ben & Jerry's stock at almost twice its current market price and wanted to take their profits. In the end, Unilever won; Ben & Jerry's was acquired by Unilever in a hostile takeover.[16] Despite fears that the company's social mission would end, it didn't happen. Though neither Ben Cohen nor Jerry Greenfield are involved in the current management of the company, they have returned to their social activism roots and are heavily involved in numerous social initiatives sponsored by the company.

The original version of this chapter contained H5P content. You may want to remove or replace this element.

Chapter Video: Business Structures

Here is a short video providing a simple and straightforward recap of the key points of each form of business ownership.

A YouTube element has been excluded from this version of the text. You can view it online here: pb.libretexts.org/biz3/?p=73

(Copyrighted material)

Key Takeaways

1. A **soleproprietorship,** a business owned by only one person, accounts for 72% of all U.S. businesses.
2. Advantages include: complete control for the owner, easy and inexpensive to form, and owner gets to keep all of the profits.
3. Disadvantages include: unlimited liability for the owner, complete responsibility for talent and financing, and business dissolves if the owner dies.
4. A **general partnership** is a business owned jointly by two or more people, and accounts for about 10% of all U.S. businesses.
5. Advantages include: more resources and talents come with an increase in partners, and the business can continue even after the death of a partner.
6. Disadvantages include: partnership disputes, unlimited liability, and shared profits.
7. 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.
8. A **corporation** is a legal entity that's separate from the parties who own it, the shareholders who invest by buying shares of stock. Corporations are governed by a Board of Directors, elected by the shareholders.
9. Advantages include: limited liability, easier access to financing, and unlimited life for the corporation.
10. Disadvantages include: the agency problem, double taxation, and incorporation expenses and regulations.
11. A **limited-liabilitycompany** (LLC) is a business structure that combines the tax treatment of a partnership with the liability protection of a corporation.
12. A **not-for-profitcorporation** is an organization formed to serve some public purpose rather than for financial gain. It enjoys favorable tax treatment.

13. A **merger** occurs when two companies combine to form a new company.
14. An **acquisition** is the purchase of one company by another with no new company being formed. A hostile takeover occurs when a company is purchased even though the company's management and Board of Directors do not want to be acquired.

Chapter 6 Text References and Image Credits

Image Credits: Chapter 6

Figure 6.1: Dismas (2010).**"**Ben Cohen and Jerry Greenfield in 2010**."** CC by SA 3.0***Retrieved from:*** https://en.Wikipedia.org/wiki/Ben_%26_Jerry%27s – /media/File:Ben_and_Jerry.jpg**.**

Figure 6.2: "Types of U.S. Businesses." Data source: "Number of Tax Returns, Receipts, and Net Income by Type of Business." *Census.gov*. Retrieved from: www.census.gov/prod/2011pubs/12statab/business.pdf

Video Credits: Chapter 6

"Business Structures." (Bean Counter). March 9, 2014. Retrieved from: https://www.youtube.com/watch?v=z-GLrHhuDEM

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CHAPTER OVERVIEW

5: Marketing

5.1: Why It Matters - Marketing Mix

5.2: Product

5.3: Promotion

5.4: Place

5.5: Price

5.6: Putting It Together- Marketing Mix

5.1: Why It Matters - Marketing Mix

Why explain how organizations use the marketing mix to market to their target customers?

Why did Red Bull sponsor Felix Baumgartner's record-breaking free fall from outer space? Why does Anheuser-Busch pay millions of dollars for a 30-second television during the Superbowl? Why does Verizon Wireless put its name on concert venues and amphitheaters around the country? Think about these three examples and how appropriate the strategy is to the target market. Energy drinks and skydiving are a great matchup, and football and beer are a natural fit. What about cell phones and concerts, though? Who goes to concerts? The same people who have the heaviest cellular phone usage—teenagers and young adults. There is a method to all of this madness we call marketing. In short, all of these companies have determined that their efforts, although costly, support a marketing strategy that will give them the highest return on their marketing dollars and reach their target customers most effectively. Using an appropriate quantity of each component of what we refer to as the "marketing mix" helps businesses meet their sales goals. This is what we will explore in depth in the coming readings.

5.2: Product

What you'll learn to do: explain common product marketing strategies and how organizations use them

Often when we hear the word *marketing*, we think about promotion or perhaps only advertising, but product is the core of the marketing mix. Product defines what will be priced, promoted, and distributed. If you are able to create and deliver a product that provides exceptional value to your target customer, the rest of the marketing mix is easier to manage. A successful product makes every aspect of a marketer's job easier—and more fun.

Learning Objectives

- Explain the elements and benefits of branding
- Describe the product life cycle
- Explain the stages of the new-product development process

Consumer Product Categories

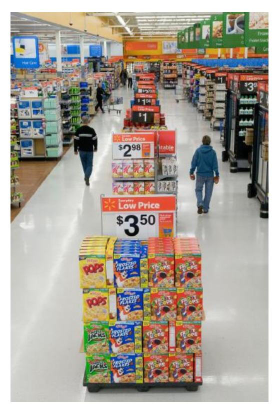
A product is a bundle of attributes (features, functions, benefits, and uses) that a person receives in an exchange. In essence, the term "product" refers to anything offered by a firm to provide customer satisfaction, tangible or intangible. Thus, a product may be an idea (recycling), a physical good (a pair of sneakers), a service (banking), or any combination of the three.[1]

Broadly speaking, products fall into one of two categories: consumer products and business products (also called industrial products and B2B products). Consumer products are purchased by the final consumer. Business products are purchased by other industries or firms and can be classified as *production goods*—i.e., raw materials or component parts used in the production of the final product—or *support goods*—such as machinery, fixed equipment, software systems, and tools that assist in the production process.[2] Some products, like computers, for instance, may be both consumer products and business products, depending on who purchases and uses them.

The product fills an important role in the marketing mix because it is the core of the exchange. Does the product provide the features, functions, benefits, and uses that the target customer expects and desires? Throughout our discussion of product we will focus on the target customer. Often companies become excited about their capabilities, technologies, and ideas and forget the perspective of the customer. This leads to investments in product enhancements or new products that don't provide value to the customer—and, as a result, are unsuccessful.

Consumer products are often classified into four groups related to different kinds of buying decisions: convenience, shopping, specialty, and unsought products. These are described below.

Convenience Products



A convenience product is an inexpensive product that requires a minimum amount of effort on the part of the consumer in order to select and purchase it. Examples of convenience products are bread, soft drinks, pain reliever, and coffee. They also include headphones, power cords, and other items that are easily misplaced.

From the consumer's perspective, little time, planning, or effort go into buying convenience products. Often product purchases are made on impulse, so availability is important. Consumers have come to expect a wide variety of products to be conveniently located at their local supermarkets. They also expect easy online purchase options and low-cost, quick shipping for those purchases. Convenience items are also found in vending machines and kiosks.

For convenience products, the primary marketing strategy is extensive distribution. The product must be available in every conceivable outlet and must be easily accessible in these outlets. These products are usually of low unit value, and they are highly standardized. Marketers must establish a high level of brand awareness and recognition. This is accomplished through extensive mass advertising, sales promotion devices such as coupons and point-of-purchase displays, and effective packaging. Yet, the key is to convince resellers (wholesalers and retailers) to carry the product. If the product is not available when, where, and in a form the consumer desires, the convenience product will fail.

Shopping Products

In contrast, consumers want to be able to compare products categorized as shopping products. Shopping products are usually more expensive and are purchased occasionally. The consumer is more likely to compare a number of options to assess quality, cost, and features.

Although many shopping goods are nationally advertised, in the marketing strategy it is often the ability of the retailer to differentiate itself that generates the sale. If you decide to buy a TV at BestBuy, then you are more likely to evaluate the range of options and prices that BestBuy has to offer. It becomes important for BestBuy to provide a knowledgeable and effective sales person and have the right pricing discounts to offer you a competitive deal. BestBuy might also offer you an extended warranty package or in-store service options. While shopping in BestBuy, consumers can easily check prices and options for online retailers, which places even greater pressure on BestBuy to provide the best total value to the shopper. If the retailer can't make the sale, product turnover is slower, and the retailer will have a great deal of their capital tied up in inventory.

There is a distinction between heterogeneous and homogeneous shopping products. Heterogeneous shopping products are unique. Think about shopping for clothing or furniture. There are many stylistic differences, and the shopper is trying to find the best stylistic match at the right price. The purchase decision with heterogeneous shopping products is more likely to be based on finding the right fit than on price alone.

In contrast, homogeneous shopping products are very similar. Take, for example, refrigerators. Each model has certain features that are available at different price points, but the basic functions of all of the models are very similar. A typical shopper will look for the lowest price available for the features that they desire.

Specialty Products

Specialty goods represent the third product classification. From the consumer's perspective, these products are so unique that it's worth it to go to great lengths to find and purchase them. Almost without exception, price is not the principle factor affecting the sales of specialty goods. Although these products may be custom-made or one-of-a-kind, it is also possible that the marketer has been very successful in differentiating the product in the mind of the consumer.

Blizzcon attendees, 2014

For example, some consumers feel a strong attachment to their hair stylist or barber. They are more likely to wait for an appointment than schedule time with a different stylist.

Another example is the annual Blizzcon event produced by Blizzard Entertainment. The $200 tickets sell out minutes after they are released, and they are resold at a premium. At the event, attendees get the chance to learn about new video games and play games that have not yet been released. They can also purchase limited-edition promotional items. From a marketer's perspective, in Blizzcon the company has succeeded in creating a specialty product that has incredibly high demand. Moreover, Blizzard's customers are paying for the opportunity to be part of a massive marketing event.

It is generally desirable for a marketer to lift her product from the shopping to the specialty class—and keep it there. With the exception of price-cutting, the entire range of marketing activities is needed to accomplish this.

Unsought Products

Unsought products are those the consumer never plans or hopes to buy. These are either products that the customer is unaware of or products the consumer hopes not to need. For example, most consumers hope never to purchase pest control services and try to avoid purchasing funeral plots. Unsought products have a tendency to draw aggressive sales techniques, as it is difficult to get the attention of a buyer who is not seeking the product.

Elements and Benefits of Branding

What Is a Brand?

As we start our exploration of brand and its role in marketing, take a few minutes to watch the following video about Coca-Cola, which is perhaps one of the most iconic brands of all time. As you watch this video, look and listen for the all the different elements that contribute to the thing we call a "brand."

Click here to read a transcript of the video.

Brands are interesting, powerful concoctions of the marketplace that create tremendous value for organizations and for individuals. Because brands serve several functions, we can define the term “brand” in the following ways:

1. **A brand is an identifier:** a name, sign, symbol, design, term, or some combination of these things that identifies an offering and helps simplify choice for the consumer.
2. **A brand is a promise:** the promise of what a company or offering will provide to the people who interact with it.
3. **A brand is an asset:** a reputation in the marketplace that can drive price premiums and customer preference for goods from a particular provider.
4. **A brand is a set of perceptions:** the sum total of everything individuals believe, think, see, know, feel, hear, and experience about a product, service, or organization.
5. **A brand is “mind share”:** the unique position a company or offering holds in the customer’s mind, based on their past experiences and what they expect in the future.

A brand consists of all the features that distinguish the goods and services of one seller from another: name, term, design, style, symbols, customer touch points, etc. Together, all elements of the brand work as a psychological trigger or stimulus that causes an association to all other thoughts one has had about this brand.

Brands are a combination of tangible and intangible elements, such as the following:

- Visual design elements (i.e., logo, color, typography, images, tagline, packaging, etc.)
- Distinctive product features (i.e. quality, design sensibility, personality, etc.)
- Intangible aspects of customers’ experience with a product or company (i.e. reputation, customer experience, etc.)

Branding–the act of creating or building a brand–may take place at multiple levels: company brands, individual product brands, or branded product lines. Any entity that works to build consumer loyalty can also be considered a brand, such as celebrities (Lady Gaga, e.g.), events (Susan G. Komen Race for the Cure, e.g.), and places (Las Vegas, e.g.).

Brands Create Market Perceptions

A successful brand is much more than just a name or logo. As suggested in one of the definitions above, brand is the sum of perceptions about a company or product in the minds of consumers. Effective brand building can create and sustain a strong, positive, and lasting impression that is difficult to displace. Brands provide external cues to taste, design, performance, quality, value, or other desired attributes if they are developed and managed properly. Brands convey positive or negative messages about a company, product, or service. Brand perceptions are a direct result of past advertising, promotion, product reputation, and customer experience.

A brand can convey multiple levels of meaning, including the following:

As an automobile brand, the Mercedes-Benz logo suggests high prestige.

1. **Attributes**: specific product features. The Mercedes-Benz brand, for example, suggests expensive, well-built, well-engineered, durable vehicles.
2. **Benefits**: attributes translate into functional and emotional benefits. Mercedes automobiles suggest prestige, luxury, wealth, reliability, self-esteem.
3. **Values**: company values and operational principles. The Mercedes brand evokes company values around excellence, high performance, power.
4. **Culture**: cultural elements of the company and brand. Mercedes represents German precision, discipline, efficiency, quality.
5. **Personality**: strong brands often project a distinctive personality. The Mercedes brand personality combines luxury and efficiency, precision and prestige.
6. **User**: brands may suggest the types of consumers who buy and use the product. Mercedes drivers might be perceived and classified differently than, for example, the drivers of Cadillacs, Corvettes, or BMWs.

Brands Create an Experience

Effective branding encompasses everything that shapes the perception of a company or product in the minds of customers. Names, logos, brand marks, trade characters, and trademarks are commonly associated with brand, but these are just part of the picture. Branding also addresses virtually every aspect of a customer's experience with a company or product: visual design, quality, distinctiveness, purchasing experience, customer service, and so forth. Branding requires a deep knowledge of customers and how they experience the company or product. Brand-building requires long-term investment in communicating about and delivering the unique value embodied in a company's "brand," but this effort can bring long-term rewards.

In consumer and business-to-business markets, branding can influence whether consumers will buy the product and how much they are willing to pay. Branding can also help in new product introduction by creating meaning, market perceptions, and differentiation where nothing existed previously. When companies introduce a new product using an existing brand name (a brand extension or a branded product line), they can build on consumers' positive perceptions of the established brand to create greater receptivity for the new offering.

Brands Create Value

The Dunkin' Donuts logo, which includes an image of a DD cup of coffee, makes it easy to spot anywhere. The coffee is known for being a good value at a great price.

Brands create value for consumers and organizations in a variety of ways.

Value of Branding for the Consumer

Brands help simplify consumer choices. Brands help create trust, so that a person knows what to expect from a branded company, product, or service. Effective branding enables the consumer to easily identify a desirable company or product because the features and benefits have been communicated effectively. Positive, well-established brand associations increase the likelihood that consumers will select, purchase, and consume the product. Dunkin' Donuts, for example, has an established logo and imagery familiar to many U.S. consumers. The vivid colors and image of a DD cup are easily recognized and distinguished from competitors, and many associate this brand with tasty donuts, good coffee, and great prices.

Value of Branding for Product and Service Providers

The Starbucks brand is associated with premium, high-priced coffee.

For companies and other organizations that produce goods, branding helps create loyalty. It decreases the risk of losing market share to the competition by establishing a competitive advantage customers can count on. Strong brands often command premium pricing from consumers who are willing to pay more for a product they know, trust, and perceive as offering good value. Branding can be a great vehicle for effectively reaching target audiences and positioning a company relative to the competition. Working in conjunction with positioning, brand is the ultimate touchstone to guide choices around messaging, visual design, packaging, marketing, communications, and product strategy.

For example, Starbucks' loyal fan base values and pays premium prices for its coffee. Starbucks' choices about beverage products, neighborhood shops, the buying experience, and corporate social responsibility all help build the Starbucks brand and communicate its value to a global customer base.

Value of Branding for the Retailer

Retailers such as Target, Safeway, and Walmart create brands of their own to create a loyal base of customers. Branding enables these retailers to differentiate themselves from one another and build customer loyalty around the unique experiences they provide. Retailer brand building may focus around the in-store or online shopping environment, product selection, prices, convenience, personal service, customer promotions, product display, etc.

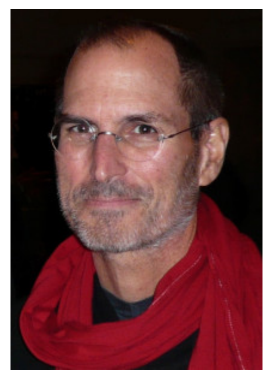
Retailers also benefit from carrying the branded products customers want. Brand-marketing support from retailers or manufacturers can help attract more customers (ideally ones who normally don't frequent an establishment). For example, a customer who truly values organic brands might decide to visit a Babies R Us to shop for organic household cleaners that are safe to use around babies. This customer might have learned that a company called BabyGanics, which brands itself as making "safe, effective, natural household solutions," was only available at this particular retailer.

Common Branding Strategies

Managing Brands As Strategic Assets

As organizations establish and build strong brands, they can pursue a number of strategies to continue developing them and extending their value to stakeholders (customers, retailers, supply chain and distribution partners, and of course the organization itself).

Brand Ownership



Steve Jobs, co-founder and CEO of Apple

Who "owns" the brand? The legal owner of a brand is generally the individual or entity in whose name the legal registration has been filed. Operationally speaking, brand ownership should be the responsibility of an organization's management and employees. Brand ownership is about building and maintaining a brand that reflects your principles and values. Brand *building* is about effectively persuading customers to believe in and purchase your product or service. Iconic brands, such as Apple and Disney, often have a history of visionary leaders who champion the brand, evangelize about it, and build it into the organizational culture and operations.

Branding Strategies

A branding strategy helps establish a product within the market and to build a brand that will grow and mature. Making smart branding decisions up front is crucial since a company may have to live with their decisions for a long time. The following are commonly used branding strategies:

"Branded House" Strategy

A "branded house" strategy (sometimes called a "house brand") uses a strong brand—typically the company name—as the identifying brand name for a range of products (for example, Mercedes Benz or Black & Decker) or a range of subsidiary brands (such as Cadbury Dairy Milk or Cadbury Fingers). Because the primary focus and investment is in a single, dominant "house" brand, this approach can be simpler and more cost effective in the long run when it is well aligned with broader corporate strategy.

"House of Brands" Strategy

Kool-Aid Man

With the "house of brands" strategy, a company invests in building out a variety of individual, product-level brands. Each of these brands has a separate name and may not be associated with the parent company name at all. These brands may even be in de facto competition with other brands from the same company. For example, Kool-Aid and Tang are two powdered beverage products, both owned by Kraft Foods. The "house of brands" strategy is well suited to companies that operate across many product categories at the same time. It allows greater flexibility to introduce a variety of different products, of differing quality, to be sold without confusing the consumer's perception of what business the company is in or diluting brand perceptions about products that target different tiers or types of consumers within the same product category.

Private-Label or Store Branding

Also called store branding, private-label branding has become increasingly popular. In cases where the retailer has a particularly strong identity, the private label may be able to compete against even the strongest brand leaders and may outperform those products that are not otherwise strongly branded. The northeastern U.S. grocery chain Wegman's offers many grocery products that carry the Wegman's brand name. Meanwhile national grocery chain Safeway offers several different private label "store" brands: Safeway Select, Organics, Signature Cafe, and Primo Taglio, among others.[3]

"No-Brand" Branding

A number of companies successfully pursue "no-brand" strategies by creating packaging that imitates generic-brand simplicity. "No brand" branding can be considered a type of branding since the product is made conspicuous by the absence of a brand name. "Tapa Amarilla" or "Yellow Cap" in Venezuela during the 1980s is a prime example of no-brand strategy. It was recognized simply by the color of the cap of this cleaning products company.

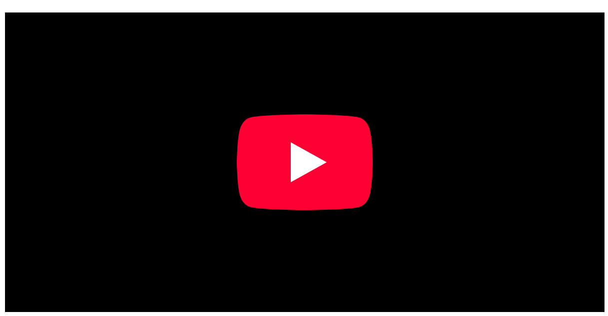
Personal and Organizational Brands

Personal and organizational branding are strategies for developing a brand image and marketing engine around individual people or groups. Personal branding treats persons and their careers as products to be branded and sold to target audiences. Organizational branding promotes the mission, goals, and/or work of the group being branded. The music and entertainment industries provide many examples of personal and organizational branding. From Justin Bieber to George Clooney to Kim Kardashian, virtually any celebrity today is a personal brand. Likewise, bands, orchestras, and other artistic groups typically cultivate an organizational (or group) brand. Faith branding is a variant of this brand strategy, which treats religious figures and organizations as brands seeking to increase their following. Mission-driven organizations such the Girl Scouts of America, the Sierra Club, the National Rifle Association (among millions of others) pursue organizational branding to expand their membership, resources, and impact.

Place Branding

The developing fields of place branding and nation branding work on the assumption that places compete with other places to win over people, investment, tourism, economic development, and other resources. With this in mind, public administrators, civic leaders, and business groups may team up to "brand" and promote their city, region, or nation among target audiences. Depending on the goals they are trying to achieve, targets for these marketing initiatives may be real-estate developers, employers and business investors, tourists and tour/travel operators, and so forth. While place branding may focus on any given geographic area or destination, nation branding aims to measure, build, and manage the reputation of countries.

The city-state Singapore is an early, successful example of nation branding. The edgy Las Vegas "What Happens Here, Stays Here" campaign, shown in in the following video, is a well-known example of place branding.



Co-Branding

Co-branding is an arrangement in which two established brands collaborate to offer a single product or service that carries both brand names. In these relationships, generally both parties contribute something of value to the new offering that neither would have been able to achieve independently. Effective co-branding builds on the complementary strengths of the existing brands. It can also allow each brand an entry point into markets in which they would not otherwise be credible players.

The following are some examples of co-branded offerings:

- Delta Airlines and American Express offer an entire family of co-branded credit cards; other airlines offer similar co-branded cards that offer customer rewards in terms of frequent flyer points and special offers.

Fiat 500 "Barbie"

- Home furnishings company Pottery Barn and the paint manufacturer Benjamin Moore co-brand seasonal color palettes for home interior paints
- Fashion designer Liz Lange designs a ready-to-wear clothing line co-branded with and sold exclusively at Target stores
- Auto maker Fiat and toy maker Mattel teamed up to celebrate Barbie's fiftieth anniversary with the nail-polish-pink Fiat 500 Barbie car.

Co-branding is a common brand-building strategy, but it can present difficulties. There is always risk around how well the market will receive new offerings, and sometimes, despite the best-laid plans, co-branded offerings fall flat. Also, these arrangements often involve complex legal agreements that are difficult to implement. Co-branding relationships may be unevenly matched, with the partners having different visions for their collaboration, placing different priority on the importance of the co-branded venture, or one partner holding significantly more power than the other in determining how they work together. Because co-branding impacts the existing brands, the partners may struggle with how to protect their current brands while introducing something new and possibly risky.

Brand Licensing

Campbell's "Star Wars" Soup. Source: http://www.campbells.com/star-wars/

Brand licensing is the process of leasing or renting the right to use a brand in association with a product or set of products for a defined period and within a defined market, geography, or territory. Through a licensing agreement, a firm (licensor) provides some tangible or intangible asset to another firm (licensee) and grants that firm the right to use the licensor's brand name and related brand assets in return for some payment. The licensee obtains a competitive advantage in this arrangement, while the licensor obtains inexpensive access to the market in question.

Licensing can be extremely lucrative for the owner of the brand, as other organizations pay for permission to produce products carrying a licensed name. The Walt Disney Company was an early pioneer in brand licensing, and it remains a leader in this area with its wildly popular entertainment and toy brands: Star Wars, Disney Princesses, Toy Story, Mickey Mouse, and so on. Toy manufacturers, for example, pay millions of dollars and vie for the rights to produce and sell products affiliated with these "super-brands."

Line Extensions and Brand Extensions

Organizations use line extensions and brand extensions to leverage and increase brand equity.

Diet Coke is a line extension of the Coke brand.

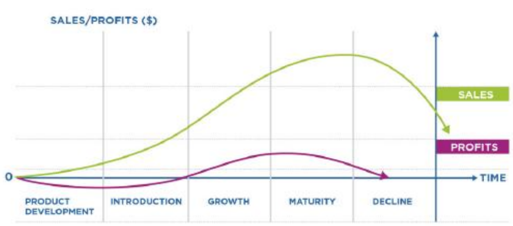
A company creates a **line extension** when it introduces a new variety of offering within the same product category. To illustrate with the food industry, a company might add new flavors, package sizes, nutritional content, or products containing special additives in line extensions. Line extensions aim to provide more variety and hopefully capture more of the market within a given category. More than half of all new products introduced each year are line extensions. For example, M&M candy varieties such as peanut, pretzel, peanut butter, and dark chocolate are all line extensions of the M&M brand. Diet Coke™ is a line extension of the parent brand Coke ™. While the products have distinct differences, they are in the same product category.

A **brand extension** moves an existing brand name into a new product category, with a new or somehow modified product. In this scenario, a company uses the strength of an established product to launch a product in a different category, hoping the popularity of the original brand will increase receptivity of the new product. An example of a brand extension is the offering of Jell-O pudding pops in addition to the original product, Jell-O gelatin. This strategy increases awareness of the brand name and increases profitability from offerings in more than one product category.

Line extensions and brand extensions are important tools for companies because they reduce financial risk associated with new-product development by leveraging the equity in the parent brand name to enhance consumers' perceptions and receptivity towards new products. Due to the established success of the parent brand, consumers will have instant recognition of the product name and be more likely to try the new line extension.

Stages of the Product Life Cycle

A company has to be good at both developing new products and managing them in the face of changing tastes, technologies, and competition. Products generally go through a life cycle with predictable sales and profits. Marketers use the product life cycle to follow this progression and identify strategies to influence it. The product life cycle (PLC) starts with the product's development and introduction, then moves toward withdrawal or eventual demise. This progression is shown in the graph, below.



PRODUCT LIFE CYCLE

The five stages of the PLC are:

1. Product development
2. Market introduction
3. Growth
4. Maturity
5. Decline

The table below shows common characteristics of each stage.

Common Characteristics	
0. Product development stage	1. investment is made 2. sales have not begun 3. new product ideas are generated, operationalized, and tested

1. Market introduction stage	1. costs are very high 2. slow sales volumes to start 3. little or no competition 4. demand has to be created 5. customers have to be prompted to try the product 6. makes little money at this stage
2. Growth stage	1. costs reduced due to economies of scale 2. sales volume increases significantly 3. profitability begins to rise 4. public awareness increases 5. competition begins to increase with a few new players in establishing market 6. increased competition leads to price decreases
3. Maturity stage	1. costs are lowered as a result of increasing production volumes and experience curve effects 2. sales volume peaks and market saturation is reached 3. new competitors enter the market 4. prices tend to drop due to the proliferation of competing products 5. brand differentiation and feature diversification is emphasized to maintain or increase market share 6. profits decline
4. Decline stage	1. costs increase due to some loss of economies of scale 2. sales volume declines 3. prices and profitability diminish 4. profit becomes more a challenge of production/distribution efficiency than increased sales

Using the Product Life Cycle

The product life cycle can be a useful tool in planning for the life of the product, but it has a number of limitations.

Not all products follow a smooth and predictable growth path. Some products are tied to specific business cycles or have seasonal factors that impact growth. For example, enrollment in higher education tracks closely with economic trends. When there is an economic downturn, more people lose jobs and enroll in college to improve their job prospects. When the economy improves and more people are fully employed, college enrollments drop. This does not necessarily mean that education is in decline, only that it is in a down cycle.

Furthermore, evidence suggests that the PLC framework holds true for industry segments but not necessarily for individual brands or projects, which are likely to experience greater variability.[4]

Of course, changes in other elements of the marketing mix can also affect the performance of the product during its life cycle. Change in the competitive situation during each of these stages may have a much greater impact on the marketing approach than the PLC itself. An effective promotional program or a dramatic lowering of price may improve the sales picture in the decline period, at least temporarily. Usually the improvements brought about by non-product tactics are relatively short-lived, and basic alterations to product offerings provide longer benefits.

Whether one accepts the S-shaped curve as a valid sales pattern or as a pattern that holds only for some products (but not for others), the PLC concept can still be very useful. It offers a framework for dealing systematically with product marketing issues and activities. The marketer needs to be aware of the generalizations that apply to a given product as it moves through the various stages.

Marketing through the Product Cycle

There are some common marketing considerations associated with each stage of the PLC. How marketers think about the marketing mix and the blend of promotional activities–also known as the promotion mix–should reflect a product's life-cycle stage and progress toward market adoption. These considerations cannot be used as a formula to guarantee success, but they can function as guidelines for thinking about budget, objectives, strategies, tactics, and potential opportunities and threats.

Keep in mind that we will discuss the new-product development process next, so it is not covered here.

Market Introduction Stage

Think of the market introduction stage as the product launch. This phase of the PLC requires a significant marketing budget. The market is not yet aware of the product or its benefits. Introducing a product involves convincing consumers that they have a problem or need which the new offering can uniquely address. At its core, messaging should convey, "This product is a great idea! You want this!" Usually a promotional budget is needed to create broad awareness and educate the market about the new product. To achieve these goals, often a product launch includes promotional elements such as a new Web site (or significant update to the existing site), a press release and press campaign, and a social media campaign.

There is also a need to invest in the development of the distribution channels and related marketing support. For a B2B product, this often requires training the sales force and developing sales tools and materials for direct and personal selling. In a B2C market, it might include training and incentivizing retail partners to stock and promote the product.

Pricing strategies in the introduction phase are generally set fairly high, as there are fewer competitors in the market. This is often offset by early discounts and promotional pricing.

Google Glass

It is worth noting that the launch will look different depending on how new the product is. If the product is a completely new innovation that the market has not seen before, then there is a need to both educate the market about the new offering and build awareness of it. In 2013 when Google launched Google Glass—an optical head-mounted computer display—it had not only to get the word out about the product but also help prospective buyers understand what it was and how it might be used. Google initially targeted tech-savvy audiences most interested in novelty and innovation (more about them later when we discuss *diffusion of innovation*). By offering the new product with a lot of media fanfare and limited availability, Google's promotional strategy ignited demand among these segments. Tech bloggers and insiders blogged and tweeted about their Google Glass adventures, and word-of-mouth sharing about the new product spread rapidly. You can imagine that this was very different from the launch of Wheat Thins Spicy Buffalo crackers, an extension of an existing product line, targeting a different audiences (retailers, consumers) with promotional activities that fit the product's marketing and distribution channels. The Google Glass situation was also different from the launch of Tesla's home battery. In that case Tesla offered a new line of home products from a company that had previously only offered automobiles. Breaking into new product categories and markets is challenging even for a well-regarded company like Tesla. As you might expect, the greater the difference in new products from a company's existing offerings, the greater the complexity and expense of the introduction stage.

One other consideration is the maturity of the product. Sometimes marketers will choose to be conservative during the marketing introduction stage when the product is not yet fully developed or proven, or when the distribution channels are not well established. This might mean initially introducing the product to only one segment of the market, doing less promotion, or limiting distribution (as with Google Glass). This approach allows for early customer feedback but reduces the risk of product issues during the launch.

While we often think of an introduction or launch as a single event, this phase can last several years. Generally a product moves out of the introduction stage when it begins to see rapid growth, though what counts as "rapid growth" varies significantly based on the product and the market.

Growth Stage

Once rapid growth begins, the product or industry has entered the growth stage. When a product category begins to demonstrate significant growth, the market usually responds: new competitors enter the market, and larger companies acquire high-growth companies and products.

These emerging competitive threats drive new marketing tactics. Marketers who have been seeking to build broad market awareness through the introduction phase must now differentiate their products from competitors, emphasizing unique features that appeal to target customers. The central thrust of market messaging and promotion during this stage is "This brand is the best!" Pricing also becomes more competitive and must be adjusted to align with the differentiation strategy.

Often in the growth phase the marketer must pay significant attention to distribution. With a growing number of customers seeking the product, more distribution channels are needed. Mass marketing and other promotional strategies to reach more customers and segments start to make sense for consumer-focused markets during the growth stage. In business-to-business markets, personal selling and sales promotions often help open doors to broader growth. Marketers often must develop and support new distribution channels to meet demand. Through the growth phase, distribution partners will become more experienced selling the product and may require less support over time.

The primary challenges during the growth phase are to identify a differentiated position in the market that allows the product to capture a significant portion of the demand and to manage distribution to meet the demand.

Maturity Stage

When growth begins to plateau, the product has reached the maturity phase. In order to achieve strong business results through the maturity stage, the company must take advantage of economies of scale. This is usually a period in which marketers manage budget carefully, often redirecting resources toward products that are earlier in their life cycle and have higher revenue potential.

At this stage, organizations are trying to extract as much value from an established product as they can, typically in a very competitive field. Marketing messages and promotions seek to remind customers about a great product, differentiate from competitors, and reinforce brand loyalty: "Remember why this brand is the best." As mentioned in the previous section, this late in the life cycle, promotional tactics and pricing discounts are likely to provide only short-term benefits. Changes to product have a better chance of yielding more sustained results.

In the maturity stage, marketers often focus on niche markets, using promotional strategies, messaging, and tactics designed to capture new share in these markets. Since there is no new growth, the emphasis shifts from drawing new customers to the market to winning more of the existing market. The company may extend a product line, adding new models that have greater appeal to a smaller segment of the market.

Often, distribution partners will reduce their emphasis on mature products. A sales force will shift its focus to new products with more growth potential. A retailer will reallocate shelf space. When this happens the manufacturer may need to take on a stronger role in driving demand.

We have repeatedly seen this tactic in the soft drink industry. As the market has matured, the number of different flavors of large brands like Coke and Pepsi has grown significantly. We will look at other product tactics to extend the growth phase and manage the maturity phase in the next section.

Decline Stage

Once a product or industry has entered decline, the focus shifts almost entirely to eliminating costs. Little if any marketing spending goes into products in this life stage, because the marketing investment is better spent on other priorities. For goods, distributors will seek to eliminate inventory by cutting prices. For services, companies will reallocate staff to ensure that delivery costs are in check. Where possible, companies may initiate a planned obsolescence process. Commonly technology companies will announce to customers that they will not continue to support a product after a set obsolescence date.

Often a primary focus for marketers during this stage is to transition customers to newer products that are earlier in the product life cycle and have more favorable economics. Promotional activities and marketing communications, if any, typically focus on making this transition successful among brand-loyal segments who still want the old product. A typical theme of marketing activity is "This familiar brand is still here, but now there's something even better."

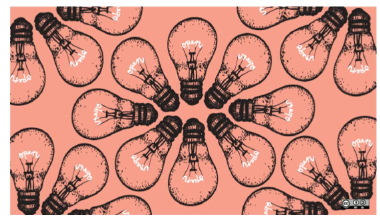
The New-Product Development Process

There are probably as many varieties of new-product development systems as there are types of companies, but most of them share the same basic steps or stages—they are just executed in different ways. Below, we have divided the process into eight stages, grouped into three phases. Many of the activities are performed repeatedly throughout the process, but they become more concrete as the product idea is refined and additional data are gathered. For example, at each stage of the process, the product team is asking,

"Is this a viable product concept?" but the answers change as the product is refined and more market perspectives can be added to the evaluation.

Phase I: Generating and Screening Ideas	Phase II: Developing New Products	Phase III: Commercializing New Products
Stage 1: Generating New Product Ideas	Stage 4: Business Case Analysis	Stage 6: Test Marketing
Stage 2: Screening Product Ideas	Stage 5: Technical and Marketing Development	Stage 7: Launch
Stage 3: Concept Development and Testing		

Stage 1: Generating New Product Ideas



Generating new product ideas is a creative task that requires a particular way of thinking. Coming up with ideas is easy, but generating good ideas is another story. Companies use a range of internal and external sources to identify new product ideas. A SWOT analysis might suggest strengths in existing products that could be the basis for new products or market opportunities. Research might identify market and customer trends. A competitive analysis might expose a hole in the company's product portfolio. Customer focus groups or the sales team might identify unmet customer needs. Many amazing products are also the result of lucky mistakes—product experiments that don't meet the intended goal but have an unintended and interesting application. For example, 3M scientist Dr. Spencer Silver invented Post-It Notes in a failed experiment to create a super-strong adhesive.[5]

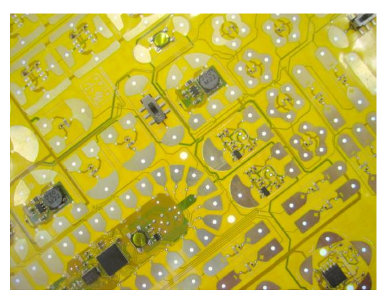
The key to the idea generation stage is to explore possibilities, knowing that most will not result in products that go to market.

Stage 2: Screening Product Ideas

The second stage of the product development process is idea screening. This is the first of many screening points. At this early stage much is *not* known about the product and its market opportunity. Still, product ideas that do not meet the organization's objectives should be rejected at this stage. If a poor product idea is allowed to pass the screening stage, it wastes effort and money in later stages until it is abandoned. Even more serious is the possibility of screening out a worthwhile idea and missing a significant market opportunity. For this reason, this early screening stage allows many ideas to move forward that may not eventually go to market.

At this early stage, product ideas may simply be screened through some sort of internal rating process. Employees might rate the product ideas according to a set of criteria, for example; those with low scores are dropped and only the highest ranked products move forward.

Stage 3: Concept Development and Testing



Today, it is increasingly common for companies to run some small concept test in a real marketing setting. The *product concept* is a synthesis or a description of a product idea that reflects the core element of the proposed product. Marketing tries to have the most accurate and detailed product concept possible in order to get accurate reactions from target buyers. Those reactions can then be used to inform the final product, the marketing mix, and the business analysis.

New tools for technology and product development are available that support the rapid development of prototypes which can be tested with potential buyers. When concept testing can include an actual product prototype, the early test results are much more reliable. Concept testing helps companies avoid investing in bad ideas and at the same time helps them catch and keep outstanding product ideas.

Stage 4: Business Case Analysis

Before companies make a significant investment in a product’s development, they need to be sure that it will bring a sufficient return.

The company seeks to answer such questions as the following:

1. What is the market opportunity for this product?
2. What are the costs to bring the product to market?
3. What are the costs through the stages of the product life cycle?
4. Where does the product fit in the product portfolio and how will it impact existing product sales?
5. How does this product impact the brand?
6. How does this product impact other corporate objectives such as social responsibility?

The marketing budget and costs are one element of the business analysis, but the full scope of the analysis includes all revenues, costs, and other business impacts of the product.

Stage 5: Technical and Marketing Development

A product that has passed the screening and business analysis stages is ready for technical and marketing development. Technical development processes vary greatly according to the type of product. For a product with a complex manufacturing process, there is a lab phase to create specifications and an equally complex phase to develop the manufacturing process. For a service offering, there may be new processes requiring new employee skills or the delivery of new equipment. These are only two of many possible examples, but in every case the company must define both what the product is and how it will be delivered to many buyers.

While the technical development is under way, the marketing department is testing the early product with target customers to find the best possible marketing mix. Ideally, marketing uses product prototypes or early production models to understand and capture customer responses and to identify how best to present the product to the market. Through this process, product marketing must prepare a complete marketing plan—one that starts with a statement of objectives and ends with a coherent picture of product distribution, promotion, and pricing integrated into a plan of marketing action.

Stage 6: Test Marketing and Validation

Test marketing is the final stage before commercialization; the objective is to test all the variables in the marketing plan including elements of the product. Test marketing represents an actual launching of the total marketing program. However, it is done on a limited basis.

Initial product testing and test marketing are not the same. Product testing is totally initiated by the producer: he or she selects the sample of people, provides the consumer with the test product, and offers the consumer some sort of incentive to participate.

Test marketing, on the other hand, is distinguished by the fact that the test group *represents* the full market, the consumer must make a purchase decision and pay for the product, and the test product must compete with the existing products in the actual marketing environment. For these and other reasons, a market test is an accurate simulation of the broader market and serves as a method for reducing risk. It should enhance the new product’s probability of success and allow for final adjustment in the marketing mix before the product is introduced on a large scale.

Stage 7: Launch

Finally, the product arrives at the commercial launch stage. The marketing mix comes together to introduce the product to the market. This stage marks the beginning of the product life cycle.

Stage 8: Evaluation

The launch does not in any way signal the end of the marketing role for the product. To the contrary, after launch the marketer finally has real market data about how the product performs in the wild, outside the test environment. These market data initiate a new cycle of idea generation about improvements and adjustments that can be made to all elements of the marketing mix.

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1. www.ama.org/resources/Pages/...tter=P#product ↩
2. www.businessdictionary.com/de...ial-goods.html ↩
3. http://www.safeway.com/ShopStores/Br...ur-Brands.page ↩

4. Mullor-Sebastian, Alicia. “The Product Life Cycle Theory: Empirical Evidence.” Journal of International Business Studies 14.3 (1983): 95–105. ↵
5. https://en.Wikipedia.org/wiki/Post-it_note ↵

5.3: Promotion

What you'll learn to do: explain how organizations use integrated marketing communication (IMC) to support their marketing strategies

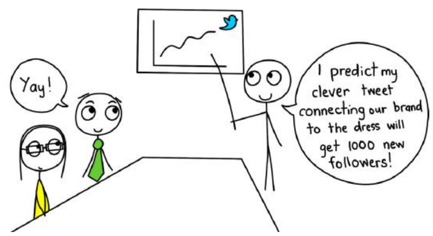
The readings in this section cover seven different marketing communication methods that are commonly used today. This section will help you become familiar with each method, common tools associated with each method, and the advantages and disadvantages of each one.

Learning Objectives

- Explain the promotion mix
- Explain how organizations use IMC to support their marketing strategies

Integrated Marketing Communication (IMC) Definition

IMC: Making an Impact with Marketing Communication



Having a great product available to your customers at a great price does absolutely nothing for you if your customers don't know about it. That's where promotion enters the picture: it does the job of connecting with your target audiences and communicating what you can offer them.

In today's marketing environment, promotion involves *integrated marketing communication* (IMC). In a nutshell, IMC involves bringing together a variety of different communication tools to deliver a common message and make a desired impact on customers' perceptions and behavior. As an experienced consumer in the English-speaking world, you have almost certainly been the target of IMC activities. (Practically every time you "like" a TV show, article, or a meme on Facebook, you are participating in an IMC effort!)

What Is Marketing Communication?

Defining marketing communication is tricky because, in a real sense, everything an organization does has communication potential. The price placed on a product communicates something very specific about the product. A company that chooses to distribute its products strictly through discount stores sends a distinct message to the market. Marketing communication refers to activities deliberately focused on promoting an offering among target audiences. The following definition helps to clarify this term:

Marketing communication includes all the messages, media, and activities used by an organization to communicate with the market and help persuade target audiences to accept its messages and take action accordingly.

Integrated marketing communication is the the process of coordinating all this activity across different communication methods. Note that a central theme of this definition is persuasion: persuading people to believe something, to desire something, and/or to do something. Effective marketing communication is goal directed, and it is aligned with an organization's marketing strategy. It aims to deliver a particular message to a specific audience with a targeted purpose of altering perceptions and/or behavior. Integrated marketing communication (IMC) makes this marketing activity more efficient and effective because it relies on multiple communication methods and customer touch points to deliver a consistent message in more ways and in more compelling ways.

The Promotion Mix: Marketing Communication Methods

The ***promotion mix*** refers to how marketers combine a range of marketing communication methods to execute their marketing activities. Different methods of marketing communication have distinct advantages and complexities, and it requires skill and experience to deploy them effectively. Not surprisingly, marketing communication methods evolve over time as new communication tools and capabilities become available to marketers and the people they target.

Seven common methods of marketing communication are described below:

- **Advertising:** Any paid form of presenting ideas, goods, or services by an identified sponsor. Historically, advertising messages have been tailored to a group and employ mass media such as radio, television, newspaper, and magazines. Advertising may also target individuals according to their profile characteristics or behavior; examples are the weekly ads mailed by supermarkets to local residents or online banner ads targeted to individuals based on the sites they visit or their Internet search terms.
- **Public relations (PR):** The purpose of public relations is to create goodwill between an organization (or the things it promotes) and the "public" or target segments it is trying to reach. This happens through unpaid or earned promotional opportunities: articles, press and media coverage, winning awards, giving presentations at conferences and events, and otherwise getting favorable attention through vehicles not paid for by the sponsor. Although organizations earn rather than pay for the PR attention they receive, they may spend significant resources on the activities, events, and people who generate this attention.
- **Personal selling:** Personal selling uses people to develop relationships with target audiences for the purpose of selling products and services. Personal selling puts an emphasis on face-to-face interaction, understanding the customer's needs, and demonstrating how the product or service provides value.
- **Sales promotion:** Sales promotions are marketing activities that aim to temporarily boost sales of a product or service by adding to the basic value offered, such as "buy one get one free" offers to consumers or "buy twelve cases and get a 10 percent discount" to wholesalers, retailers, or distributors.
- **Direct marketing:** This method aims to sell products or services directly to consumers rather than going through retailer. Catalogs, telemarketing, mailed brochures, or promotional materials and television home shopping channels are all common traditional direct marketing tools. Email and mobile marketing are two next-generation direct marketing channels.
- **Digital marketing:** Digital marketing covers a lot of ground, from Web sites to search-engine, content, and social media marketing. Digital marketing tools and techniques evolve rapidly with technological advances, but this umbrella term covers all of the ways in which digital technologies are used to market and sell organizations, products, services, ideas, and experiences.
- **Guerrilla marketing:** This newer category of marketing communication involves unconventional, innovative, and usually low-cost marketing tactics to engage consumers in the marketing activity, generate attention and achieve maximum exposure for an organization, its products, and/or services. Generally guerrilla marketing is experiential: it creates a novel situation or memorable experience consumers connect to a product or brand.

Guerrilla marketing: a lamppost transformed into a McDonald's coffeepot. Source: http://janjan-design.blogspot.com/20...loving-it.html

Most marketing initiatives today incorporate multiple methods: hence the need for IMC. Each of these marketing communication methods will be discussed in further detail later in this module.

The Objectives of Marketing Communication

The basic objectives of all marketing communication methods are (1) to communicate, (2) to compete, and (3) to convince. In order to be effective, organizations should ensure that whatever information they communicate is clear, accurate, truthful, and useful to the stakeholders involved. In fact, being truthful and accurate in marketing communications is more than a matter of integrity; it's also a matter of legality, since fraudulent marketing communications can end in lawsuits and even the criminal justice system.

Marketing communication is key to competing effectively, particularly in markets where competitors sell essentially the same product at the same price in the same outlets. Only through marketing communications may an organization find ways to appeal to certain segments, differentiate its product, and create enduring brand loyalty. Remaining more appealing or convincing than competitors' messages is an ongoing challenge.

Ideally, marketing communication is convincing: it should present ideas, products, or services in such a compelling way that target segments are led to take a desired action. The ability to persuade and convince is essential to winning new business, but it may also be necessary to reconvince and retain many consumers and customers. Just because a customer buys a particular brand once or a dozen times, or even for a dozen years, there is no guarantee that the person will stick with the original product. That is why marketers want to make sure he or she is constantly reminded of the product's unique benefits.

Common Marketing Communication Methods

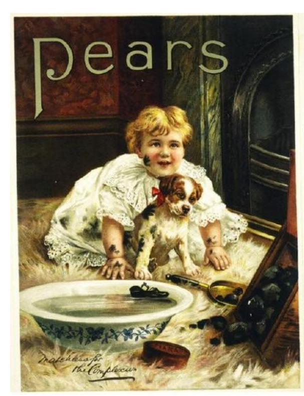
In a successfully operated campaign, all activities will be well coordinated to build on one another and increase the overall impact. For example, a single campaign might include:

- **Advertising:** A series of related, well-timed, carefully placed television ads coupled with print advertising in selected magazines and newspapers
- **Direct marketing:** Direct-to-consumer mail pieces sent to target segments in selected geographic areas, reinforcing the messages from the ads
- **Personal selling:** Preparation for customer sales representatives about the campaign to equip them to explain and demonstrate the product benefits stressed in advertising
- **Sales promotions:** In-store display materials reflecting the same messages and design as the ads, emphasizing point-of-sale impact
- **Digital marketing:** Promotional information on the organization's Web site that reflects the same messages, design, and offers reflected in the ads; ads themselves may be posted on the Website, YouTube, Facebook, and shared in other social media
- **Public relations:** A press release announcing something newsworthy in connection to the campaign focus, objectives, and target segment(s)

Advertising

Advertising is probably the first thing you think of when you think of marketing. Advertising is any paid form of communication from an identified sponsor or source that draws attention to ideas, goods, services or the sponsor itself: essentially commercials and ads (whether digital or print). Most advertising is directed toward groups rather than individuals, and advertising is usually delivered through media such as television, radio, newspapers and, increasingly, the internet. Ads are often measured in *impressions* (the number of times a consumer is exposed to an advertisement).

Advantages and Disadvantages of Advertising



As a method of marketing communication, advertising has both advantages and disadvantages. In terms of advantages, advertising creates a sense of credibility or legitimacy when an organization invests in presenting itself and its products in a public forum. Ads can convey a sense of quality and permanence, the idea that a company isn't some fly-by-night venture. Advertising allows marketers to repeat a message at intervals selected strategically. Repetition makes it more likely that the target audience will see and recall a message, which improves awareness-building results. Advertising can generate drama and human interest by featuring people and situations that are exciting or engaging. Finally, advertising is an excellent vehicle for brand building, as it can create rational and emotional connections with a company or offering that translate into goodwill.

The primary disadvantage of advertising is cost. Marketers question whether this communication method is really cost-effective at reaching large groups. Of course, costs vary depending on the medium, with television ads being very expensive to produce and place. In contrast, print and digital ads tend to be much less expensive. Along with cost is the question of how many people an advertisement actually reaches. Ads are easily tuned out in today's crowded media marketplace. Even ads that initially grab attention can grow stale over time. Because advertising is a one-way medium, there is usually little direct opportunity for consumer feedback and interaction, particularly from consumers who often feel overwhelmed by competing market messages.

Direct Marketing

Direct marketing activities bypass any intermediaries and communicate directly with the individual consumer. Direct mail is personalized to the individual consumer, based on whatever a company knows about that person's needs, interests, behaviors, and preferences. Traditional direct marketing activities include mail, catalogs, and telemarketing. The thousands of "junk mail" offers from credit card companies, bankers, and charitable organizations that flood mailboxes every year are artifacts of direct marketing. Telemarketing contacts prospective customers via the telephone to pitch offers and collect information. Today, direct marketing overlaps heavily with digital marketing, as marketers rely on email and, increasingly, mobile communications to reach and interact with consumers.

If you've ever paid off an auto loan, you may have noticed a torrent of mail offers from car dealerships right around the five-year mark. They know, from your credit history, that you're nearly done paying off your car and you've had the vehicle for several years, so you might be interested in trading up for a newer model. Based on your geography and any voter registration information, you may be targeted during election season to participate via telephone in political polls and to receive "robocalls" from candidates and parties stomping for your vote. Moving into the digital world, virtually any time you share an email address with an organization, it becomes part of a database to be used for future marketing.

Advantages and Disadvantages of Direct Marketing

Direct marketing can offer significant value to consumers by tailoring their experience in the market to things that most align with their needs and interests. If you're going to have a baby (and you don't mind people knowing about it), wouldn't you rather have Target send you special offers on baby products than on men's shoes or home improvement goods? Additionally, direct marketing can be a powerful tool for anticipating and predicting customer needs and behaviors. Over time, as companies use consumer data to understand their target audiences and market dynamics, they can develop more effective campaigns and offers.

Among the leading disadvantages of direct marketing are, not surprisingly, customer concerns about privacy and information security. Data-driven direct marketing might seem a little creepy or even nefarious, and certainly it can be when marketers are insensitive or unethical in their use of consumer data. Direct marketing also takes place in a crowded, saturated market in which people are only too willing to toss junk mail and unsolicited email into trash bins without a second glance. Electronic spam filters screen out many email messages, so people may never even see email messages from many of the organizations that send them.

Heavy reliance on data also leads to the challenge of keeping databases and contact information up to date and complete, a perennial problem for many organizations. Finally, direct marketing implies a direct-to-customer business model that inevitably requires companies to provide an acceptable level of customer service and interaction to win new customers and retain their business.

Personal Selling

Personal selling uses in-person interaction to sell products and services. This type of communication is carried out by sales representatives, who are the personal connection between a buyer and a company or a company's products or services. In addition to enhancing customer relationships, this type of marketing communications tool can be a powerful source of customer feedback, as well.

Effective personal selling addresses the buyer's needs and preferences without making him or her feel pressured. Good salespeople offer advice, information, and recommendations, and they can help buyers save money and time during the decision process. The seller should give honest responses to any questions or objections the buyer has and show that the company cares more about meeting the buyer's needs than making the sale. Attending to these aspects of personal selling contributes to a strong, trusting relationship between buyer and seller.[1]

Advantages and Disadvantages of Personal Selling

The most significant strength of personal selling is its flexibility. Salespeople can tailor their presentations to fit the needs, motives, and behavior of individual customers. A salesperson can gauge the customer's reaction to a sales approach and immediately adjust the message to facilitate better understanding. A salesperson is also in an excellent position to encourage the customer to act. The one-on-one interaction of personal selling means that a salesperson can effectively respond to and overcome objections—e.g., concerns or reservations about the product—so that the customer is more likely to buy. Salespeople can also offer many customized reasons that might spur a customer to buy, whereas an advertisement offers a limited set of reasons that may not persuade everyone in the target audience.

Personal selling also minimizes wasted effort. Advertisers can spend a lot of time and money on a mass-marketing message that reaches many people outside the target market (but doesn't result in additional sales). In personal selling, the sales force pinpoints the target market, makes a contact, and focuses effort that has a strong probability of leading to a sale.

High cost is the primary disadvantage of personal selling. With increased competition, higher travel and lodging costs, and higher salaries, the cost per sales contract continues to rise. Many companies try to control sales costs by compensating sales representatives through commissions or by using complementary techniques, such as telemarketing, direct mail, toll-free numbers for interested customers, and online communication with qualified prospects. Another weakness of personal selling is message inconsistency. Many salespeople view themselves as independent from the organization, so they design their own sales techniques, use their own message strategies, and engage in questionable ploys to generate sales. (You'll recall our discussion in the ethics module about the unique challenges that B2B salespeople face.) As a result, it can be difficult to find a unified company or product message within a sales force or between the sales force and the rest of the marketing mix.

Sales Promotions

Sales promotions are a marketing communication tool for stimulating revenue or providing incentives or extra value to distributers, sales staff, or customers over a short time period. Sales promotion activities include special offers, displays, demonstrations, and other nonrecurring selling efforts that aren't part of the ordinary routine. As an additional incentive to buy, these tools can be directed at consumers, retailers and other distribution partners, or the manufacturer's own sales force.

Companies use many different forms of media to communicate about sales promotions, such as printed materials like posters, coupons, direct mail pieces and billboards; radio and television ads; digital media like text messages, email, websites and social media, and so forth.

Most consumers are familiar with common sales promotion techniques including samples, coupons, point-of-purchase displays, premiums, contents, loyalty programs, and rebates.

Advantages and Disadvantages of Sales Promotions[2]

In addition to their primary purpose of boosting sales in the near term, companies can use consumer sales promotions to help them understand price sensitivity. Coupons and rebates provide useful information about how pricing influences consumers' buying behavior. Sales promotions can also be a valuable–and sometimes sneaky–way to acquire contact information for current and prospective customers. Many of these offers require consumers to provide their names and other information in order to participate. Electronically-scanned coupons can be linked to other purchasing data, to inform organizations about buying habits. All this information can be used for future marketing research, campaigns and outreach.

Consumer sales promotions can generate loyalty and enthusiasm for a brand, product, or service. Frequent flyer programs, for example, motivate travelers to fly on a preferred airline even if the ticket prices are somewhat higher. If sales have slowed, a promotion such as a sweepstakes or contest can spur customer excitement and (re)new interest in the company's offering. Sales promotions are a good way of energizing and inspiring customer action.

Trade promotions offer distribution channel partners financial incentives that encourage them to support and promote a company's products. Offering incentives like prime shelf space at a retailer's store in exchange for discounts on products has the potential to build and enhance business relationships with important distributors or businesses. Improving these relationships can lead to higher sales, stocking of other product lines, preferred business terms and other benefits.

Sales promotions can be a two-edged sword: if a company is continually handing out product samples and coupons, it can risk tarnishing the company's brand. Offering too many freebies can signal to customers that they are not purchasing a prestigious or "limited" product. Another risk with too-frequent promotions is that savvy customers will hold off purchasing until the next promotion, thus depressing sales.

Often businesses rush to grow quickly by offering sales promotions, only to see these promotions fail to reach their sales goals and target customers. The temporary boost in short term sales may be attributed to highly price-sensitive consumers looking for a deal, rather than the long-term loyal customers a company wants to cultivate. Sales promotions need to be thought through, designed and promoted carefully. They also need to align well with the company's larger business strategy. Failure to do so can be costly in terms of dollars, profitability and reputation.

If businesses become overly reliant on sales growth through promotions, they can get trapped in short-term marketing thinking and forget to focus on long-term goals. If, after each sales dip, a business offers another sales promotion, it can be damaging to the long-term value of its brand.

Digital Marketing

Digital marketing is an umbrella term for using a digital tools to promote and market products, services, organizations and brands. As consumers and businesses become more reliant on digital communications, the power and importance of digital marketing have increased. There are several essential tools in the digital marketing tool kit: email, mobile marketing, websites, content marketing and search-engine optimization (SEO), and social media marketing. For now, we'll focus on websites and social media.

Websites represent an all-in-one storefront, a display counter, and a megaphone for organizations to communicate in the digital world. For digital and bricks-and-mortar businesses, websites are a primary channel for communicating with current and prospective customers as well as other audiences. A good website provides evidence that an organization is real, credible, and legitimate.

Social media are distinctive for their networking capabilities: they allow people to reach and interact with one another through interconnected networks. This "social" phenomenon changes the power dynamic in marketing: no longer is the marketer the central gatekeeper for all communication about a product, service, brand, or organization. Social media allows for organic dialogue and activity to happen directly between individuals, unmediated by a company. Companies can (and should) listen, learn, and find ways to participate authentically.

Advantages and Disadvantages of Digital Marketing

Websites have so many advantages that there is almost no excuse for a business not to have one. Effective website marketing declares to the world that an organization exists, what value it offers, and how to do business. Websites can be an engine for generating customer data and new business leads. An electronic storefront is often dramatically less expensive than a physical storefront, and it can serve customers virtually anywhere in the world with internet access. Websites are very flexible and easy to alter. Organizations can try out new strategies, content and tactics at relatively low cost to see what works and where the changes pay off.

The advantages and benefits of social media marketing focus heavily on the two-way and even multidirectional communication between customers, prospects, and advocates for your company or brand. By listening and engaging in social media, organizations are better equipped to understand and respond to market sentiment. Social media helps organizations identify and cultivate advocates for its products, services, and brand, including the emergence of customers who can become highly credible, trusted voices to help you sell.

At the same time, digital marketing strategies carry costs and risks. Websites require some investment of time and money to set up and maintain. Organizations should make wise, well-researched decisions about information infrastructure and website hosting, to ensure their sites remain operational with good performance and uptime. Companies that capture and maintain customer data through their websites must be vigilant about information security to prevent hackers from stealing sensitive customer data.

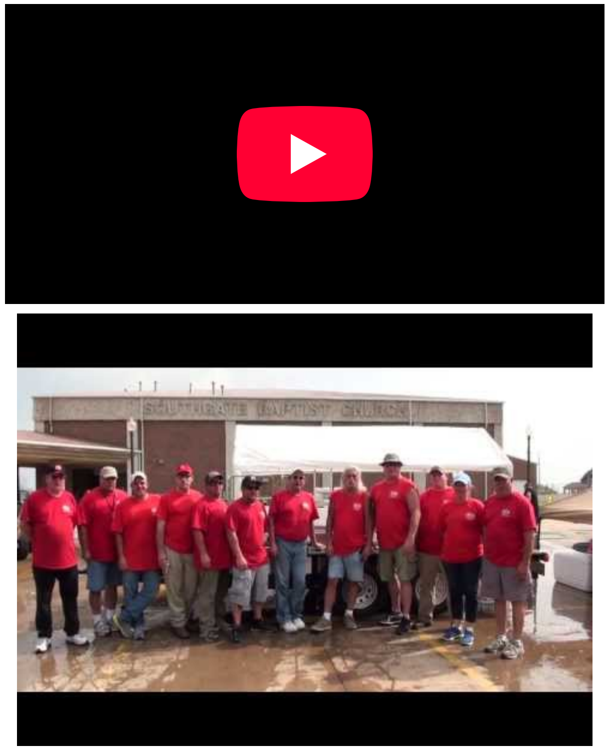
Social media also carry a number of inherent challenges. Social media are dynamic environments that requires significant effort to monitor and stay current on. It is also difficult to continually create "share-worthy" content. The variety of social media tools makes it a challenge to understand which platforms to use for which target audiences and calls to action. Crisis communications can be difficult, too, particularly in the public environment of social media, in which it is difficult to contain or control communication. This means it can be difficult to mitigate the impact of a crisis on the brand. One of the biggest challenges facing organizations is determining who in the organization should "own" the social media platforms for the organization. Too few hands to help means the burden of content creation is high on a single individual. However, too many people often results in duplication of efforts or conflicting content.

Public Relations

Public relations (PR) is the process of maintaining a favorable image and building beneficial relationships between an organization and the public communities, groups, and people it serves. Unlike advertising, which tries to create favorable impressions through paid messages, public relations does not pay for attention and publicity. Instead, PR strives to earn a favorable image by drawing attention to newsworthy and attention-worthy activities of the organization and its customers. For this reason, PR is often referred to as "free advertising."

In fact, PR is not a costless form of promotion. It requires salaries to be paid to people who oversee and execute PR strategy. It also involves expenses associated with events, sponsorships and other PR-related activities.

The following video, about Tyson Foods' "Meals That Matter" program, shows how one company cooked up an idea that is equal parts public relations and corporate social responsibility (CSR). The video covers the Tyson disaster-relief team delivering food to the residents of Moore, Oklahoma, shortly after tornados struck the area on May 20, 2013. The company received favorable publicity following the inauguration of the program in 2012. (You can read one of the articles here: "Tyson Foods Unveils Disaster Relief Mobile Feeding Unit.")



Advantages and Disadvantages of Public Relations

Because PR activity is earned rather than paid, it tends to carry more credibility and weight. For example, when a news story profiles a customer's successful experience with a company and its products, people tend to view this type of article as less biased (and therefore more credible) than a paid advertisement. The news story comes from an objective reporter who feels the story is worth telling. Meanwhile an advertisement on a similar topic would be viewed with skepticism because it is a paid placement from a biased source: the ad sponsor.

Using IMC to Support Marketing Strategies

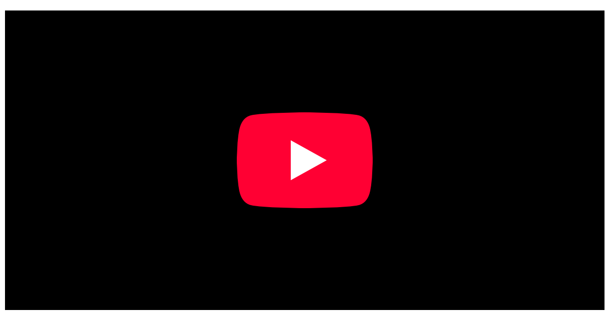
Determining which marketing communication methods and tools to use and how best to combine them is a challenge for any marketer planning a promotional strategy. To aid the planning process, marketing managers often use a campaign approach. A *campaign* is a planned, coordinated series of marketing communication efforts built around a single theme or idea and designed to reach a particular goal. For years, the term "campaign" has been used in connection with advertising, and this term applies equally well to the entire IMC program.

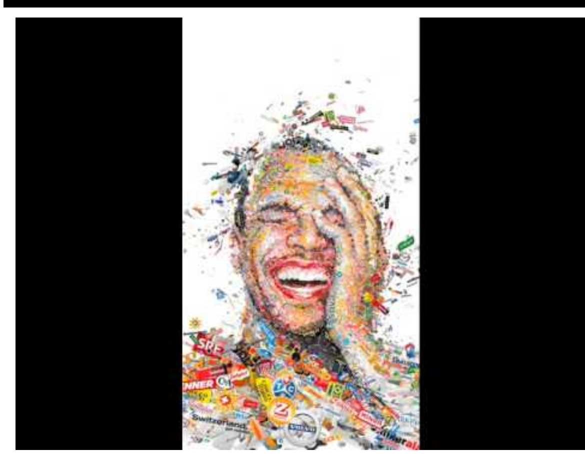
Organizations may conduct many types of IMC campaigns, and several may be run concurrently. Geographically, a firm may have a local, regional, or national campaign, depending upon the available funds, objectives, and market scope. One campaign may be aimed at consumers and another at wholesalers and retailers. Different marketing campaigns might target different segments simultaneously, delivering messages and using communication tools tailored to each segment. Marketers use a marketing plan (sometimes called an IMC plan) to track and execute a set of campaigns over a given period of time.

A campaign revolves around a theme, a central idea, focal point, or purpose. This theme permeates all IMC efforts and works to unify the campaign. The theme may refer to the campaign's goals—for example, KCRW "Capital Campaign" launched by the popular Los Angeles-based public radio station KCRW to raise $48 million to build a new state-of-the-art media facility for its operations. The theme may also refer to the shift in customer attitudes or behavior that a campaign focuses on—such as new-member campaigns launched by numerous member organizations, from professional associations to school parent-teacher organizations. A theme might take the form of a slogan, such as Coca-Cola's "Taste the Feeling" campaign or DeBeers' "A diamond is forever."

Clear Channel is a marketing company that specializes in outdoor advertising. For their latest advertising campaign in Switzerland, they created a slogan-based theme, "Where Brands Meet People," and asked their clients to participate in dramatizing it. Dozens of Swiss companies gave their logo to be used as individual "tiles" in three colorful mosaic portraits.[3] These mosaics, two of which are below, appeared on the Web and on the streets of Switzerland. Click here if you want to see a higher-resolution version that reveals all the brands that make up the mosaics.

Some of the billboards appeared in animated form, as below:





Marketing campaigns may also adopt themes that refer to a stage in the product life cycle, such as McDonald's 2015 "All-Day Breakfast" rollout campaign. Some organizations use the same theme for several campaigns; others develop a different theme for each new campaign.

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1. http://smallbusiness.chron.com/strat...ues-15747.html ↩
2. http://edwardlowe.org/digital-librar...omotional-mix/ ↩
3. www.behance.net/gallery/2987...ds-meet-people ↩

5.4: Place

What you'll learn to do: explain common product distribution strategies and how organizations use them

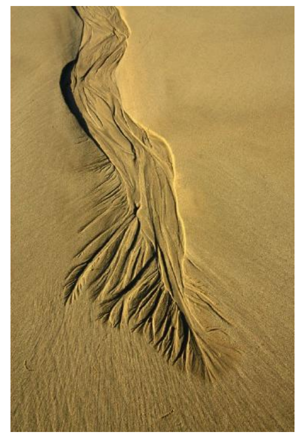
Distribution channels—which is "place" in the four Ps—cover all the activities needed to transfer the ownership of goods and move them from the point of production to the point of consumption. In this section you'll learn more about distribution channels and some of the common strategies companies use to take advantage of them.

Learning Objectives

- Describe the channel partners that support distribution channels
- Describe the different types of retailers businesses use to distribute products
- Differentiate between supply chains and distributions channels

Channels of Distribution

Evolution of Channels of Distribution



As consumers, we take for granted that when we go to a supermarket the shelves will be filled with the products we want; when we are thirsty there will be a Coke machine or bar around the corner, and we count on being able to get online and find any product available for purchase and quick delivery. Of course, if we give it some thought, we realize that this magic is not a given and that hundreds of thousands of people plan, organize, and labor long hours to make this convenience available. It has not always been this way, and it is still not this way in many other parts of the world.

Looking back over time, the channel structure in primitive culture was virtually nonexistent. The family or tribal group was almost entirely self-sufficient. The group was composed of individuals who were both communal producers and consumers of whatever goods and services could be made available. As economies evolved, people began to specialize in some aspect of economic activity. They engaged in farming, hunting, or fishing, or some other basic craft. Eventually this specialized skill produced excess products, which they exchanged or traded for needed goods that had been produced by others. This exchange process or barter marked the beginning of formal channels of distribution. These early channels involved a series of exchanges between two parties who were producers of one product and consumers of the other.

With the growth of specialization, particularly industrial specialization, and with improvements in methods of transportation and communication, channels of distribution have become longer and more complex. Thus, corn grown in Illinois may be processed into corn chips in West Texas, which are then distributed throughout the United States. Or, turkeys raised in Virginia are sent to New York so that they can be shipped to supermarkets in Virginia. Channels do not always make sense.

The channel mechanism also operates for service products. In the case of medical care, the channel mechanism may consist of a local physician, specialists, hospitals, ambulances, laboratories, insurance companies, physical therapists, home care professionals, and so on. All of these individuals are interdependent and could not operate successfully without the cooperation and capabilities of all the others.

Based on this relationship, we define a ***channel of distribution***, also called a marketing channel, as sets of interdependent organizations involved in the process of making a product or service available for use or consumption, as well as providing a payment mechanism for the provider.

This definition implies several important characteristics of the channel.

First, the channel consists of *organizations*, some under the control of the producer and some outside the producer's control. Yet all must be recognized, selected, and integrated into an efficient channel arrangement.

Second, the channel management process is continuous and requires continuous monitoring and reappraisal. The channel operates twenty-four hours a day and exists in an environment where change is the norm.

Finally, channels should have certain distribution objectives guiding their activities. The structure and management of the marketing channel is thus, in part, a function of a firm's distribution objective. It's also a part of the marketing objectives, especially the need to make an acceptable profit. Channels usually represent the largest costs in marketing a product.

Channel Flows

One traditional framework that has been used to express the channel mechanism is the concept of flow. These flows reflect the many linkages that tie channel members and other agencies together in the distribution of goods and services. From the perspective of the channel manager, there are five important flows.

1. **Product flow:** the movement of the physical product from the manufacturer through all the parties who take physical possession of the product until it reaches the ultimate consumer
2. **Negotiation flow:** the institutions that are associated with the actual exchange processes
3. **Ownership flow:** the movement of title through the channel
4. **Information flow:** the individuals who participate in the flow of information either up or down the channel
5. **Promotion flow:** the flow of persuasive communication in the form of advertising, personal selling, sales promotion, and public relations

monster channel flow

The figure below maps the channel flows for the Monster Energy drink (and many other energy drink brands). Why is Monster's relationship with Coca-Cola so valuable? Every single flow passes through bottlers and distributors in order to arrive in supermarkets where the product will be available to consumers.

Coca-Cola explains the importance of the bottlers in the distribution network:

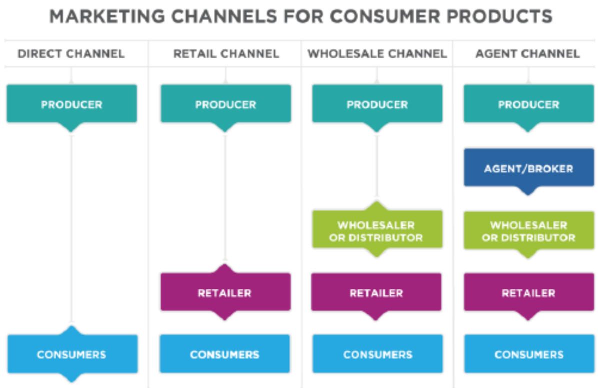
> "While many view our Company as simply "Coca-Cola," our system operates through multiple local channels. Our Company manufactures and sells concentrates, beverage bases and syrups to bottling operations, owns the brands and is responsible for consumer brand marketing initiatives. Our bottling partners manufacture, package, merchandise and distribute the final branded beverages to our customers and vending partners, who then sell our products to consumers.
>
> *All bottling partners work closely with customers — grocery stores, restaurants, street vendors, convenience stores, movie theaters and amusement parks, among many others — to execute localized strategies developed in partnership with our Company. Customers then sell our products to consumers at a rate of more than 1.9 billion servings a day.*[1]"

Revisiting the channel flows we find that the bottlers and distributors play a role in each flow. Examples of the flows are listed below. Remember, while the consumer is the individual who eventually consumes the drink, the supermarkets, restaurants, and other outlets are Coca-Cola's customers.

- Negotiation flow: the bottlers buy concentrate, sell product and collect revenue from customers
- Information flow: bottlers communicate product options to customers and communicate demand and needs to Coca-Cola
- Promotion flow: bottlers communicate benefits and provide promotional materials to customers

Channel Partners

While channels can be very complex, there is a common set of channel structures that can be identified in most transactions. Each channel structure includes different organizations. Generally, the organizations that collectively support the distribution channel are referred to as **channel partners**.



The **direct channel** is the simplest channel. In this case, the producer sells directly to the consumer. The most straightforward examples are producers who sell in small quantities. If you visit a farmer's market, you can purchase goods directly from the farmer or craftsman. There are also examples of very large corporations who use the direct channel effectively, especially for B2B transactions. Services may also be sold through direct channels, and the same principle applies: an individual buys a service directly from the provider who delivers the service.

Examples of the direct channel include:

- Etsy.com online marketplace
- Farmer's markets
- Oracle's personal sales team that sells software systems to businesses
- A bake sale

Retailers are companies in the channel that focuses on selling directly to consumers. You are likely to participate in the **retail channel** almost every day. The retail channel is different from the direct channel in that the retailer doesn't produce the product. The retailer markets and sells the goods on behalf of the producer. For consumers, retailers provide tremendous contact efficiency by creating one location where many products can be purchased. Retailers may sell products in a store, online, in a kiosk, or on your doorstep. The emphasis is not the specific location but on selling directly to the consumer.

Examples of retailers include:

- Walmart discount stores
- Amazon online store
- Nordstrom department store
- Dairy Queen restaurant

From a consumer's perspective, the **wholesale channel** looks very similar to the retail channel, but it also involves a wholesaler. A wholesaler is primarily engaged in buying and usually storing and physically handling goods in large quantities, which are then resold (usually in smaller quantities) to retailers or to industrial or business users. The vast majority of goods produced in an advanced economy have wholesaling involved in their distribution. Wholesale channels also include manufacturers who operate sales offices to perform wholesale functions, and retailers who operate warehouses or otherwise engage in wholesale activities.

Examples of wholesalers include:

- Christmas-tree wholesalers who buy from growers and sell to retail outlets
- Restaurant food suppliers
- Clothing wholesalers who sell to retailers

The broker or **agent channel** includes one additional intermediary. Agents and brokers are different from wholesalers in that they *do not take title* to the merchandise. In other words, they do not own the merchandise because they neither buy nor sell. Instead, brokers bring buyers and sellers together and negotiate the terms of the transaction: agents represent either the buyer or seller, usually on a permanent basis; brokers bring parties together on a temporary basis. Think about a real-estate agent. They do not buy your home and sell it to someone else; they market and arrange the sale of the home. Agents and brokers match up buyers and sellers, or add expertise to create a more efficient channel.

Examples of brokers include:

- An insurance broker, who sells insurance products from many companies to businesses and individuals
- A literary agent, who represents writers and their written works to publishers, theatrical producers, and film producers
- An export broker, who negotiates and manages transportation requirements, shipping, and customs clearance on behalf of a purchaser or producer

It's important to note that the larger and more complex the flow of materials from the initial design through purchase, the more likely it is that multiple channel partners may be involved, because each channel partner will bring unique expertise that increases the efficiency of the process. If an intermediary is not adding value, they will likely be removed over time, because the cost of managing and coordinating with each intermediary is significant.

The Role of Wholesale Intermediaries

While we are probably most familiar with the retail channel, wholesalers play an important role as intermediaries. Intermediaries act as a link in the distribution process, but the roles they fill are broader than simply connecting the different channel partners. Wholesalers, often called "merchant wholesalers," help move goods between producers and retailers.

For example, McLane Company Inc. is among the largest wholesalers in the United States. The breadth of its operations is described on the company Web site:

> *"McLane Foodservice and wholly owned subsidiary, Meadowbrook Meat Company, Inc., operates 80 distribution centers across the U.S. and one of the nation's largest private fleets. The company buys, sells, and delivers more than 50,000 different consumer products to nearly 90,000 locations across the U.S. In addition, McLane provides alcoholic beverage distribution through its wholly owned subsidiary, Empire Distributors, Inc. McLane is a wholly owned unit of Berkshire Hathaway Inc. and employs more than 20,000 teammates.[2]"*

Let's look at each of the functions that a merchant wholesaler fulfills.

Purchasing

Wholesalers purchase very large quantities of goods directly from producers or from other wholesalers. By purchasing large quantities or volumes, wholesalers are able to secure significantly lower prices.

Imagine a situation in which a farmer grows a very large crop of potatoes. If he sells all of the potatoes to a single wholesaler, he will negotiate one price and make one sale. Because this is an efficient process that allows him to focus on farming (rather than searching for additional buyers), he will likely be willing to negotiate a lower price. Even more important, because the wholesaler has such strong buying power, the wholesaler is able to force a lower price on every farmer who is selling potatoes.

The same is true for almost all mass-produced goods. When a producer creates a large quantity of goods, it is most efficient to sell all of them to one wholesaler, rather than negotiating prices and making sales with many retailers or an even larger number of consumers. Also, the bigger the wholesaler is, the more likely it will have significant power to set attractive prices.

Warehousing and Transportation

Once the wholesaler has purchased a mass quantity of goods, it needs to get them to a place where they can be purchased by consumers. This is a complex and expensive process. McLane Company operates eighty distribution centers around the country. Its distribution center in Northfield, Missouri, is 560,000 square feet big and is outfitted with a state-of-the art inventory tracking system that allows it to manage the diverse products that move through the center.[3] It relies on its own vast trucking fleet to handle the transportation.

Grading and Packaging

Wholesalers buy a very large quantity of goods and then break that quantity down into smaller lots. The process of breaking large quantities into smaller lots that will be resold is called bulk breaking. Often this includes physically sorting, grading, and assembling the goods. Returning to our potato example, the wholesaler would determine which potatoes are of a size and quality to sell individually and which are to be packaged for sale in five-pound bags.[4]

Risk Bearing

Wholesalers either take title to the goods they purchase, or they own the goods they purchase. There are two primary consequences of this, both of which are both very important to the distribution channel. First, it means that the wholesaler finances the purchase of the goods and carries the cost of the goods in inventory until they are sold. Because this is a tremendous expense, it drives wholesalers to be accurate and efficient in their purchasing, warehousing, and transportation processes.

Second, wholesalers also bear the risk for the products until they are delivered. If goods are damaged in transport and cannot be sold, then the wholesaler is left with the goods and the cost. If there is a significant change in the value of the products between the time of the purchase from the producer and the sale to the retailer, the wholesaler will absorb that profit or loss.

Marketing

Often, the wholesaler will fill a role in the promotion of the products that it distributes. This might include creating displays for the wholesaler's products and providing the display to retailers to increase sales. The wholesaler may advertise its products that are carried by many retailers.

Wholesalers also influence which products the retailer offers. For example, McLane Company was a winner of the 2016 Convenience Store News Category Captains, in recognition for its innovations in providing the right products to its customers. McLane created unique packaging and products featuring movie themes, college football themes, and other special occasion branding that were designed to appeal to impulse buyers. They also shifted the transportation and delivery strategy to get the right products in front of consumers at the time they were most likely to buy. Its convenience store customers are seeing sales growth, as is the wholesaler.[5]

Distribution

As distribution channels have evolved, some retailers, such as Walmart and Target, have grown so large that they have taken over aspects of the wholesale function. Still, it is unlikely that wholesalers will ever go away. Most retailers rely on wholesalers to fulfill the functions that we have discussed, and they simply do not have the capability or expertise to manage the full distribution process. Plus, many of the functions that wholesalers fill are performed most efficiently at scale. Wholesalers are able to focus on creating efficiencies for their retail channel partners that are very difficult to replicate on a small scale.

Retailers that Distribute Products

Retailing involves all activities required to market consumer goods and services to ultimate consumers who are purchasing for individual or family needs.

By definition, B2B purchases are not included in the retail channel since they are not made for individual or family needs. In practice this can be confusing because many retail outlets do serve both consumers and business customers—like Home Depot, which has a Pro Xtra program for selling directly to builders and contractors. Generally, retailers that have a significant B2B or wholesale business report those numbers separately in their financial statements, acknowledging that they are separate lines of business within the same company. Those with a pure retail emphasis do not seek to exclude business purchasers. They simply focus their offering to appeal to individual consumers, knowing that some businesses may also choose to purchase from them.

We typically think of a store when we think of a retail sale, even though retail sales occur in other places and settings. For instance, they can be made by a Pampered Chef salesperson in someone's home. Retail sales also happen online, through catalogs, by automatic vending machines, and in hotels and restaurants. Nonetheless, despite tremendous growth in both nontraditional retail outlets and online sales, most retail sales still take place in brick-and-mortar stores.

Beyond the distinctions in the products they provide, there are structural differences among retailers that influence their strategies and results. One of the reasons the retail industry is so large and powerful is its diversity. For example, stores vary in size, in the kinds of services that are provided, in the assortment of merchandise they carry, and in their ownership and management structures.

Department Stores

Department stores are characterized by their very wide product mixes. That is, they carry many different types of merchandise, which may include hardware, clothing, and appliances. Each type of merchandise is typically displayed in a different section or department within the store. The depth of the product mix depends on the store, but department stores' primary distinction is the ability to provide a wide range of products within a single store. For example, people shopping at Macy's can buy clothing for a woman, a man, and children, as well as house wares such as dishes and luggage.

Chain Stores

The 1920s saw the evolution of the chain store movement. Because chains were so large, they were able to buy a wide variety of merchandise in large quantity discounts. The discounts substantially lowered their cost compared to costs of single unit retailers. As a result, they could set retail prices that were lower than those of their small competitors and thereby increase their share of the market. Furthermore, chains were able to attract many customers because of their convenient locations, made possible by their financial resources and expertise in selecting locations.

Supermarkets

Supermarkets evolved in the 192os and 1930s. For example, Piggly Wiggly Food Stores, founded by Clarence Saunders around 1920, introduced self-service and customer checkout counters. Supermarkets are large, self-service stores with central checkout facilities. They carry an extensive line of food items and often nonfood products. There are 37,459 supermarkets operating in the United States, and the average store now carries nearly 44,000 products in roughly 46,500 square feet of space. The average customer visits a store just under twice a week, spending just over $30 per trip. Supermarkets' entire approach to the distribution of food and household cleaning and maintenance products is to offer large assortments these goods at each store at a minimal price.

Discount Retailers

Discount retailers, like Ross Dress for Less and Grocery Outlet, are characterized by a focus on price as their main sales appeal. Merchandise assortments are generally broad and include both hard and soft goods, but assortments are typically limited to the most popular items, colors, and sizes. Traditional stores are usually large, self-service operations with long hours, free parking, and relatively simple fixtures. Online retailers such as Overstock.com have aggregated products and offered them at deep discounts. Generally, customers sacrifice having a reliable assortment of products to receive deep discounts on the available products.

Warehouse Retailers

Warehouse retailers provide a bare-bones shopping experience at very low prices. Costco is the dominant warehouse retailer, with $79.7 billion in sales in 2014. Warehouse retailers streamline all operational aspects of their business and pass on the efficiency savings to customers. Costco generally uses a cost-plus pricing structure and provides goods in wholesale quantities.

Franchises

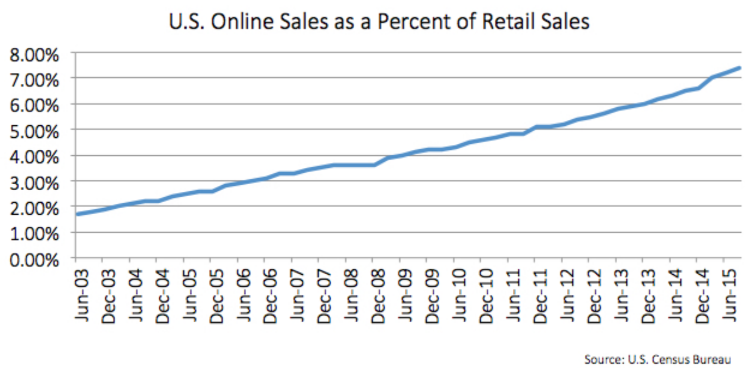
The franchise approach brings together national chains and local ownership. An owner purchases a franchise which gives her the right to use the firm's business model and brand for a set period of time. Often, the franchise agreement includes well-defined guidance for the owner, training, and on-going support. The owner, or franchisee, builds and manages the local business. *Entrepreneur* magazine posts a list each year of the 500 top franchises according to an evaluation of financial strength and stability, growth rate, and size. The 2016 list is led by Jimmy John's gourmet sandwiches, Hampton by Hilton midprice hotels, Supercuts hair salon, Servpro insurance/disaster restoration and cleaning, and Subway restaurants.

Malls and Shopping Centers

Malls and shopping centers are successful because they provide customers with a wide assortment of products across many stores. If you want to buy a suit or a dress, a mall provides many alternatives in one location. *Malls* are larger centers that typically have one or more department stores as major tenants. *Strip malls* are a common string of stores along major traffic routes, while isolated locations are freestanding sites not necessarily in heavy traffic areas. Stores in isolated locations must use promotion or some other aspect of their marketing mix to attract shoppers.

Online Retailing

Online retailing is unquestionably a dominant force in the retail industry, but today it accounts for only a small percentage of total retail sales. Companies like Amazon and Geico complete all or most of their sales online. Many other online sales result from online sales from traditional retailers, such as purchases made at Nordstrom.com. Online marketing plays a significant role in preparing the buyers who shop in stores. In a similar integrated approach, catalogs that are mailed to customers' homes drive online orders. In a survey on its Web site, Land's End found that 75 percent of customers who were making purchases had reviewed the catalog first.[6]



Catalog Retailing

Catalogs have long been used as a marketing device to drive phone and in-store sales. As online retailing began to grow, it had a significant impact on catalog sales. Many retailers who depended on catalog sales—Sears, Land's End, and J.C. Penney, to name a few—suffered as online retailers and online sales from traditional retailers pulled convenience shoppers away from catalog sales. Catalog mailings peaked in 2009 and saw a significant decrease through 2012. In 2013, there was a small increase in catalog mailings. Industry experts note that catalogs are changing, as is their role in the retail marketing process. Despite significant declines, U.S. households still receive 11.9 billion catalogs each year.[7]

Nonstore Retailing

Beyond those mentioned in the categories above, there's a wide range of traditional and innovative retailing approaches. Although the Avon lady largely disappeared at the end of the last century, there are still in-home sales from Arbonne facial products, cabi women's clothing, WineShop at Home, and others. Many of these models are based on the idea of a woman using her personal network to sell products to her friends and their friends, often in a party setting.

Vending machines and point-of-sale kiosks have long been a popular retail device. Today they are becoming more targeted, such as companies selling easily forgotten items—such as small electronics devices and makeup items—to travelers in airports.

Each of these retailing approaches can be customized to meet the needs of the target buyer or combined to span a range of needs.

Supply Chains and Distribution Channels

What Is a Supply Chain?

We have discussed the channel partners, the roles they fill, and the structures they create. Marketers have long recognized the importance of managing distribution channel partners. As channels have become more complex and the flow of business has become more global, organizations have recognized that they need to manage more than just the channel partners. They need to manage the full chain of organizations and transactions from raw materials through final delivery to the customer—in other words, **the supply chain**.

The **supply chain** is a system of organizations, people, activities, information, and resources involved in moving a product or service from supplier to customer. Supply chain activities involve the transformation of natural resources, raw materials, and components into a finished product that is delivered to the end customer.[8]

The marketing channel generally focuses on how to increase value to the customer by having the right product in the right place at the right price at the moment the customer wants to buy. The emphasis is on the providing value to the customer, and the marketing objectives usually focus on what is needed to deliver that value.

Supply chain management takes a different approach. The Council of Supply Chain Management Professionals (CSCMP) defines supply chain management as follows:

> *"Supply chain management encompasses the planning and management of all activities involved in sourcing and procurement, conversion, and all logistics management activities. Importantly, it also includes coordination and collaboration with channel partners, which can be suppliers, intermediaries, third-party service providers, and customers.*[9]"

Supply Chain vs. Marketing Channels

The supply chain and marketing channels can be differentiated in the following ways:

1. **The supply chain is broader than marketing channels.** It begins with raw materials and delves deeply into production processes and inventory management. Marketing channels are focused on bringing together the partners who can most efficiently deliver the right marketing mix to the customer in order to maximize value. Marketing channels provide a more narrow focus within the supply chain.
2. **Marketing channels are purely customer facing.** Supply chain management seeks to optimize how products are supplied, which adds a number of financial and efficiency objectives that are more internally focused. Marketing channels emphasize a stronger market view of the customer expectations and competitive dynamics in the marketplace.

3. **Marketing channels are part of the marketing mix**. Supply chain professionals are specialists in the delivery of goods. Marketers view distribution as one element of the marketing mix, in conjunction with product, price, and promotion. Supply chain management is more likely to identify the most efficient delivery partner. A marketer is more likely to balance the merits of a channel partner against the value offered to the customer. For instance, it might make sense to keep a channel partner who is less efficient but provides important benefit in the promotional strategy.

Successful organizations develop effective, respectful partnerships between the marketing and supply chain teams. When the supply chain team understands the market dynamics and the points of flexibility in product and pricing, they are better able to optimize the distribution process. When marketing has the benefit of effective supply chain management—which is analyzing and optimizing distribution within and beyond the marketing channels—greater value is delivered to customers.

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5.5: Price

What you'll learn to do: explain common pricing strategies and how organizations use them

In this section you'll learn about some very specific, yet standard pricing strategies that organizations use to meet their objectives and address consumer perceptions of value.

learning objective

- Describe the objectives businesses hope to achieve with product pricing
- Explain the methods businesses use for discounts and allowances

Customer Value and Price

Founders Jennifer Carter Fleiss (left) and Jennifer Hyman (right) at Rent the Runway headquarters

Rent the Runway is a company that lets customers borrow expensive designer dresses for a short time at a low price—to wear on a special occasion, e.g.—and then send them back. A customer can rent a Theia gown that retails for $995 for four days for the price of $150. Or, she can rent a gown from Laundry by Shelli Segal that retails for $325 for the price of $100. The company offers a 20 percent discount to first-time buyers and offers a "free second size" option to ensure that customers get the right fit.

Do the customers get a bargain when they are able to wear a designer dress for a special occasion at 15 percent of the retail price? Does the retail price matter to customers in determining value, or are they only considering the style and price they will pay for the rental?

What does value really mean in the pricing equation?

The Customer's View of Price

Whether a customer is the ultimate user of the finished product or a business that purchases components of the finished product, the customer seeks to satisfy a need through the purchase of a particular product. The customer uses several criteria to decide how much she is willing to spend in order to satisfy that need. Her preference is to pay as little as possible.

PRICE-VALUE EQUATION

VALUE = PERCEIVED BENEFITS - PERCEIVED COSTS

In order to increase value, the business can either increase the perceived benefits or reduce the perceived costs. Both are important aspects of price. If you buy a Louis Vuitton bag for $600, in return for this high price you perceive that you are getting a beautifully designed, well-made bag that will last for decades—in other words, the value is high enough for you that it can offset the cost. On the other hand, when you buy a parking pass to park in a campus lot, you are buying the convenience of a parking place close to your classes. Both of these purchases provide value at some cost. The perceived benefits are directly related to the price-value equation; some of the possible benefits are status, convenience, the deal, brand, quality, choice, and so forth. Some of these benefits tend to go hand in hand. For instance, a Mercedes Benz E750 is a very high-status brand name, and buyers expect superb quality to be part of the value equation (which makes it worth the $100,000 price tag). In other cases, there are tradeoffs between benefits. Someone living in an isolated mountain community might prefer to pay a lot more for groceries at a local store than drive sixty miles to the nearest Safeway. That person is willing to sacrifice the benefit of choice for the benefit of greater convenience.

When we talk about increasing perceived benefits, we refer to this as increasing the "value added." Identifying and increasing the value-added elements of a product are an important marketing strategy. In our initial example, Rent the Runway is providing dresses for special occasions. The price for the dress is reduced because the customer must give it back, but there are many value-added elements that keep the price relatively high, such as the broad selection of current styles and the option of trying a second size at no additional cost. In a very competitive marketplace, the value-added elements become increasingly important, as marketers use them to differentiate the product from other similar offerings.

Perceived costs include the actual dollar amount printed on the product, plus a host of additional factors. If you learn that a gas station is selling gas for 25 cents less per gallon than your local station, will you automatically buy from the lower-priced gas station? That depends. You will consider a range of other issues. How far do you have to drive to get there? Is it an easy drive or a drive through traffic? Are there long lines that will increase the time it takes to fill your tank? Is the low-cost fuel the grade or brand that you prefer? Inconvenience, poor service, and limited choice are all possible perceived costs. Other common perceived costs are the risk of making a mistake, related costs, lost opportunity, and unexpected consequences, to name but a few.

Viewing price from the customer's point of view pays off in many ways. Most notably, it helps define value–the most important basis for creating a competitive advantage.

Pricing Objectives

Companies set the prices of their products in order to achieve specific objectives. Consider the following examples.

nike

In 2014 Nike initiated a new pricing strategy. The company determined from a market analysis that its customers appreciated the value that the brand provided, which meant that it could charge a higher price for its products. Nike began to raise its prices 4–5 percent a year. Footwear News reported on the impact of their strategy:

> "The ability to raise prices is a key long-term advantage in the branded apparel and footwear industry—we are particularly encouraged that Nike is able to drive pricing while most U.S. apparel names are calling for elevated promotional [and] markdown levels in the near-term," said UBS analyst Michael Binetti. Binetti said Nike's new strategy is an emerging competitive advantage.[1]"

Nike's understanding of customer value enabled it to raise prices and achieve company growth objectives, increasing U.S. athletic footwear sales by $168 million in one year.

southwest airlines

In 2015 the U.S. airline industry lost $12 billion in value in one day because of concerns about potential price wars. When Southwest Airlines announced that it was increasing its capacity by 1 percent, the CEO of American Airlines—the world's largest airline—responded that American would not lose customers to price competition and would match lower fares. Forbes magazine reported on the consequences:

> "This induced panic among investors, as they feared that this would trigger a price war among the airlines. The investors believe that competing on prices would undermine the airline's ability to charge profitable fares, pull down their profits, and push them back into the shackles of heavy losses. Thus, the worried investors sold off stocks of major airlines, wiping out nearly $12 billion of market value of the airline industry in a single trading day.[2]"

Common Pricing Objectives

Not surprising, product pricing has a big effect on company objectives. (You'll recall that objectives are essentially a company's business goals.) Pricing can be used strategically to adjust performance to meet revenue or profit objectives, as in the Nike example above. Or, as the airline-industry example shows, pricing can also have unintended or adverse effects on a company's objectives. Product pricing will impact each of the objectives below:

- Profit objective: For example, “Increase net profit in 2016 by 5 percent”
- Competitive objective: For example, “Capture 30 percent market share in the product category”
- Customer objective: For example, “Increase customer retention”

Of course, over the long run, no company can really say, “We don’t care about profits. We are pricing to beat competitors.” Nor can the company focus only on profits and ignore how it delivers customer value. For this reason, marketers talk about a company’s “orientation” in pricing. Orientation describes the relative importance of one factor compared to the others. All companies must consider customer value in pricing, but some have an orientation toward profit. We would call this profit-oriented pricing.

Profit-Oriented Pricing

Profit-oriented pricing places an emphasis on the finances of the product and business. A business’s profit is the money left after all costs are covered. In other words, profit = revenue – costs. In profit-oriented pricing, the price per product is set higher than the total cost of producing and selling each product to ensure that the company makes a profit on each sale.

The benefit of profit-oriented pricing is obvious: the company is guaranteed a profit on every sale. There are real risks to this strategy, though. If a competitor has lower costs, then it can easily undercut the pricing and steal market share. Even if a competitor does not have lower costs, it might choose a more aggressive pricing strategy to gain momentum in the market.

Also, customers don’t really care about the company’s costs. Price is a component of the value equation, but if the product fails to deliver value, it will be difficult to generate sales.

Finally, profit-oriented pricing is often a difficult strategy for marketers to succeed with, because it limits flexibility. If the price is too high, then the marketer has to adjust other aspects of the marketing mix to create more value. If the marketer invests in the other three Ps—by, say, making improvements to the product, increasing promotion, or adding distribution channels—that investment will probably require additional budget, which will further raise the price.

It’s fairly standard for retailers to use some profit-oriented pricing—applying a standard mark-up over wholesale prices for products, for instance—but that’s rarely their only strategy. Successful retailers will also adjust pricing for some or all products in order to increase the value they provide to customers.

Competitor-Oriented Pricing

Sometimes prices are set almost completely according to competitor prices. A company simply copies the competitor’s pricing strategy or seeks to use price as one of the features that differentiates the product. That could mean either pricing the product higher than competitive products, to indicate that the firm believes it to provide greater value, or lower than competitive products in order to be a low-price solution.

This is a fairly simple way to price, especially with products whose pricing information is easily collected and compared. Like profit-oriented pricing, it carries some risks, though. Competitor-oriented pricing doesn’t fully take into account the value of the product to the customer vis-à-vis the value of competitive products. As a result, the product might be priced too low for the value it provides, or too high.

As the airline example illustrates, competitor-oriented pricing can contribute to a difficult market dynamic. If players in a market compete exclusively on price, they will erode their profits and, over time, limit their ability to add value to products.

Customer-Oriented Pricing

PRICE-VALUE EQUATION
VALUE = PERCEIVED BENEFITS - PERCEIVED COSTS

Customer-oriented pricing is also referred to as value-oriented pricing. Given the centrality of the customer in a marketing orientation (and this marketing course!), it will come as no surprise that customer-oriented pricing is the recommended pricing approach because its focus is on providing value to the customer. Customer-oriented pricing looks at the full price-value equation (Figure 1, above; discussed earlier in the module in “Demonstrating Customer Value”) and establishes the price that balances the value. The company seeks to charge the highest price *that supports the value received* by the customer.

Customer-oriented pricing requires an analysis of the customer and the market. The company must understand the buyer persona, the value that the buyer is seeking, and the degree to which the product meets the customer need. The market analysis shows competitive pricing but also pricing for substitutes.

In an attempt to bring the customer voice into pricing decisions, many companies conduct primary market research with target customers. Crafting questions to get at the value perceptions of the customer is difficult, though, so marketers often turn to something called the Van Westerndorp price-sensitivity meter. This method uses the following four questions to understand customer perceptions of pricing:

1. At what price would you consider the product to be so expensive that you would not consider buying it? (Too expensive)
2. At what price would you consider the product to be priced so low that you would feel the quality couldn't be very good? (Too cheap)
3. At what price would you consider the product starting to get expensive, such that it's not out of the question, but you would have to give some thought to buying it? (Expensive/High Side)
4. At what price would you consider the product to be a bargain—a great buy for the money? (Cheap/Good Value)

Each of these questions asks about the customer's perspective on the product value, with price as one component of the value equation.

Cost-Plus Pricing Method

Cost-Plus Pricing

Cost-plus pricing, sometimes called *gross margin pricing*, is perhaps the most widely used pricing method. The manager selects as a goal a particular gross margin that will produce a desirable profit level. Gross margin is the difference between how much the goods cost and the actual price for which it sells. This gross margin is designated by a percent of net sales. The percent chosen varies among types of merchandise. That means that one product may have a goal of 48 percent gross margin while another has a target of 33.5 percent or 2 percent.

A primary reason that the cost-plus method is attractive to marketers is that they don't have to forecast general business conditions or customer demand. If sales volume projections are reasonably accurate, profits will be on target. Consumers may also view this method as fair, since the price they pay is related to the cost of producing the item. Likewise, the marketer is sure that costs are covered.

A major disadvantage of cost-plus pricing is its inherent inflexibility. For example, department stores often find it hard to meet (and beat) competition from discount stores, catalog retailers, and furniture warehouses because of their commitment to cost-plus pricing. Another disadvantage is that it doesn't take into account consumers' perceptions of a product's value. Finally, a company's costs may fluctuate, and constant price changing is not a viable strategy.

Markups

When middlemen use the term *markup*, they are referring to the difference between the average cost and price of all merchandise in stock, for a particular department, or for an individual item. The difference may be expressed in dollars or as a percentage. For example, a man's tie costs \$14.50 and is sold for \$25.23. The dollar markup is \$10.73. The markup may be designated as a percent of the selling price or as a percent of the cost of the merchandise. In this example, the markup is 74 percent of cost (\$10.73 / \$14.50) or 42.5 percent of the retail price (\$10.73 / \$25.23).

Cost-Oriented Pricing of New Products

Certainly costs are an important component of pricing. No firm can make a profit until it covers its costs. However, the process of determining costs and setting a price based on costs does not take into account what the customer is willing to pay at the marketplace. This strategy is a bit of a trap for companies that develop products and continually add features to them, thus adding cost. Their cost-based approach leads them to add a percentage to the cost, which they pass on to customers in the form of a new, higher price. Then they are disappointed when their customers do not see sufficient value in the cost-based price.

Discounting Strategies

In addition to deciding about the base price of products and services, marketing managers must also set policies regarding the use of discounts and allowances. There are many different types of price reductions–each designed to accomplish a specific purpose. The major types are described below.

Quantity discounts are reductions in base price given as the result of a buyer purchasing some predetermined quantity of merchandise. A noncumulative quantity discount applies to each purchase and is intended to encourage buyers to make larger purchases. This means that the buyer holds the excess merchandise until it is used, possibly cutting the inventory cost of the seller and preventing the buyer from switching to a competitor at least until the stock is used. A cumulative quantity discount applies to the total bought over a period of time. The buyer adds to the potential discount with each additional purchase. Such a policy helps to build repeat purchases.

Both Home Depot and Lowe's offer a contractor discount to customers who buy more than $5,000 worth of goods. Home Depot has a tiered discount for painters, who can save as much as 20 percent off of retail once they spend $7,500.[3]

Seasonal discounts are price reductions given for out-of-season merchandise—snowmobiles discounted during the summer, for example. The intention of such discounts is to spread demand over the year, which can allow fuller use of production facilities and improved cash flow during the year.

Seasonal discounts are not always straightforward. It seems logical that gas grills are discounted in September when the summer grilling season is over, and hot tubs are discounted in January when the weather is bad and consumers spend less freely. However, the biggest discounts on large-screen televisions are offered during the weeks before the Super Bowl when demand is greatest. This strategy aims to drive impulse purchases of the large-ticket item, rather than spurring sales during the off-season.

Cash discounts are reductions on base price given to customers for paying cash or within some short time period. For example, a 2 percent discount on bills paid within 10 days is a cash discount. The purpose is generally to accelerate the cash flow of the organization and to reduce transaction costs.

Generally cash discounts are offered in a business-to-business transaction where the buyer is negotiating a range of pricing terms, including payment terms. You can imagine that if you offered to pay cash immediately instead of using a credit card at a department store, you wouldn't receive a discount.

Trade discounts are price reductions given to middlemen (e.g., wholesalers, industrial distributors, retailers) to encourage them to stock and give preferred treatment to an organization's products. For example, a consumer goods company might give a retailer a 20 percent discount to place a larger order for soap. Such a discount might also be used to gain shelf space or a preferred position in the store.

Calico Corners offers a 15 percent discount on fabrics to interior designers who are creating designs or products for their customers. They have paired this with a quantity-discounts program that offers gift certificates for buyers who purchase more than $10,000 in a year.

Personal allowances are similar strategies aimed at middlemen. Their purpose is to encourage middlemen to aggressively promote the organization's products. For example, a furniture manufacturer may offer to pay some specified amount toward a retailer's advertising expenses if the retailer agrees to include the manufacturer's brand name in the ads.

Some manufacturers or wholesalers also give retailers prize money called "spiffs," which can be passed on to the retailer's sales clerks as a reward for aggressively selling certain items. This is especially common in the electronics and clothing industries, where spiffs are used primarily with new products, slow movers, or high-margin items.

When employees in electronics stores recommend a specific brand or product to a buyer they may receive compensation from the manufacturer on top of their wages and commissions from the store.

Trade-in allowances also reduce the base price of a product or service. These are often used to help the seller negotiate the best price with a buyer. The trade-in may, of course, be of value if it can be resold. Accepting trade-ins is necessary in marketing many types of products. A construction company with a used grader worth $70,000 probably wouldn't buy a new model from an equipment company that did not accept trade-ins, particularly when other companies do accept them.

Price bundling is a very popular pricing strategy. The marketer groups similar or complementary products and charges a total price that is lower than if they were sold separately. Comcast and Direct TV both follow this strategy by combining different products and services for a set price. Similarly, Microsoft bundles Microsoft Word, Excel, Powerpoint, OneNote, and Outlook in the Microsoft Office Suite. The underlying assumption of this pricing strategy is that the increased sales generated will more than compensate for a lower profit margin. It may also be a way of selling a less popular product—like Microsoft OneNote—by combining it with popular ones. Industries such as financial services, telecommunications, and software companies make very effective use of this strategy.

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5.6: Putting It Together- Marketing Mix

Synthesis

In this module you have seen how businesses use the marketing mix to gain market share, enhance the value of their brand, and attract and retain customers in order to increase revenue and profit. Let's take a final look at this from the perspective of the most valuable brand in the world: Coca-Cola.

Coca-Cola is sold in more than two hundred countries around the world and represents nearly 43 percent of all carbonated beverages consumed in the United States annually. About 1.7 billion servings of Coke products are consumed every day. The **products** that Coca-Cola has used to capture the thirst of so many people go far beyond that iconic red can of soda. In fact, Coke makes so many different beverages that if you drank one per day, it would take you more than nine years to try them all. Coca-Cola has a product portfolio of more than 3,500 beverages (and 500 brands)—everything from sodas to energy drinks to soy-based drinks.[1]

The pricing strategy of Coca-Cola is what they refer to as ”meet-the-competition pricing”: Coca-Cola product **prices** are set around the same level as their competitors, because Coca-Cola has to be perceived as different but still affordable. Coca-Cola uses lower price points to penetrate new markets that are especially sensitive to price. They meet or beat the competition on price to raise brand awareness. Once the brand is established in the market, Coca-Cola repositions itself as the “premium” brand in comparison to its numerous competitors (Pepsi, for example). One way they accomplish this is by promoting a brand image of bringing intangible benefits in lifestyle, group affiliation, joy, and happiness . . . but the marketing strategy still focuses on an affordable premium product.

Coca-Cola has won a multitude of advertising industry awards for their innovative and effective promotional strategy. The **promotions** that Coca-Cola uses to further enhance its brand image and gain market share have included things like free hotel vouchers in Europe, Olympic sponsorship, the National Football League “Red Zone” promotion, and even “peel and win” stickers on Big Gulp cups at 7-Eleven.

Finally, the **place**, or distribution, of Coca-cola products is truly amazing. If you stacked up Coke's 2.8 million vending machines, they would take up 150.2 million cubic feet of space—the size of four Empire State Buildings.[2] But it's not just the vending machines that matter. The company achieves its global reach with local focus because of the strength of the Coca-Cola system, which comprises more than 250 bottling partners worldwide. Coca-Cola manufactures and sells concentrates, beverage bases, and syrups to bottling operations, while it owns the brands and is responsible for consumer brand marketing initiatives. Bottling partners manufacture, package, merchandise, and distribute the final branded beverages to customers and vending partners, who then sell Coca-Cola products to consumers. All bottling partners work closely with customers—grocery stores, restaurants, street vendors, convenience stores, movie theaters and amusement parks, among many others—to execute localized strategies developed in partnership with Coca Cola.[3]

What does this marketing mix result in for Coca Cola? The Coca-Cola brand is worth an estimated $83.8 billion. That's more than Budweiser, Subway, Pepsi, and KFC combined.[4]

Summary

This module covered the marketing mix in depth and the strategies companies use to develop effective marketing plans. Below is a summary of the topics covered in this module.

Product Marketing

Product is the core of the marketing mix. Product defines what will be priced, promoted, and distributed. If you are able to create and deliver a product that provides exceptional value to your target customer, the rest of the marketing mix is easier to manage. A successful product makes every aspect of a marketer's job more effective.

Pricing Strategies

When businesses make decisions about pricing, they can adopt profit-oriented pricing, competitor-oriented pricing, or customer-oriented pricing. Customer-oriented pricing focuses on the price-value equation: Value = Perceived Benefits – Perceived Costs. In order to increase value, the business can either increase the perceived benefits or reduce the perceived costs. Today's marketing tends to favor customer-oriented pricing because it prioritizes the customer and the customer's perception of value.

Place: Distribution Channels

Distribution channels cover all the activities needed to transfer the ownership of goods and move them from the point of production to the point of consumption. These activities can be organized as five important channel flows: product flow, negotiation flow, ownership flow, information flow, and promotion flow. While channels can be very complex, there is a set of channel structures that can be identified in most transactions: the direct channel, the retail channel, the wholesale channel, and the agent channel.

Promotion: Integrated Marketing Communication (IMC)

There are many different marketing communication methods that can be used in the promotion mix. Integrated marketing communication is the process of coordinating all the promotional activity across these different methods. In this course you learned about seven common marketing communication: advertising, public relations, personal selling, sales promotion, digital marketing, direct marketing, and guerrilla marketing.

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CHAPTER OVERVIEW

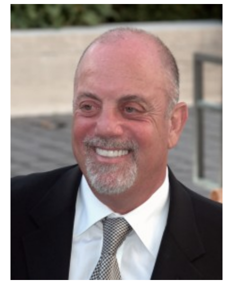
6: Accounting and Finance

6.1: Why It Matters- Accounting and Finance
6.2: Accounting in Business
6.3: Key Financial Statements
6.4: The Break-Even Point
6.5: Financial Ratios
6.6: Ethical Practices in Accounting

6.1: Why It Matters- Accounting and Finance

Why learn how to use accounting and financial principles to make informed decisions?

Billy Joel at the 2009 premiere of the Metropolitan Opera in New York City.



> *If you don't immediately recognize the face in the picture, you'd probably recognize his music.*
>
> *If you said this is Billy Joel, "The Piano Man," well done! In case you are unfamiliar with his accomplishments, read the following, from his Web site:*
>
> *"Billy Joel has had 33 Top 40 hits and 23 Grammy nominations since signing his first solo recording contract in 1972. In 1990, he was presented with a Grammy Legend Award. Inducted into the Songwriters Hall of Fame in 1992, Joel was presented with the Johnny Mercer Award, the organization's highest honor, in 2001. In 1999 he was inducted into the Rock & Roll Hall of Fame, and has received the Recording Industry Association of America Diamond Award, presented for albums that have sold over 10 million copies.*
>
> *In November, 2014, Billy Joel received The Library of Congress Gershwin Prize for Popular Song. In 2014 he also received the once-in-a-century ASCAP Centennial Award, presented to American music icons in recognition of their incomparable accomplishments in their respective music genres and beyond[1]"*

So, what is Billy Joel pop/rock icon and ex-husband of "Uptown Girl" and supermodel Christie Brinkley doing in the accounting module? Well, Joel apparently never took accounting or knew enough about its basic principles to be an *informed consumer* of his own financial information. How can we tell? Because if he had understood how to read an income statement or balance sheet, he might not have found himself on the verge of bankruptcy in 1989.

In 1989 Billy Joel filed a $90-million lawsuit against his former manager, Frank Weber, for mishandling his income and expenses. According to the court documents, just two of the charges were the following:

- Weber double-billed Joel for music videos, cheated him on expenses (including travel and accounting fees), and mortgaged Joel's copyrights for $15 million without disclosing it on Joel's financial statements.
- Weber caused phony financial statements to be issued to Joel, which painted an unrealistic picture of Joel's finances and the value of his investments and failed to reflect liabilities, guarantees, loans, and mortgages on the financial statements.

How was Joel supposed to have known this was happening and prevented it? How could understanding something about accounting have helped him? How can it help *you*?

In order to ask a question, you have to possess enough knowledge about a subject to know what to ask. Even understanding how to compare financial statements between multiple periods could have helped. Knowing what should have appeared on the various financial statements might have helped Joel spot gaps and missing information. Does that mean that understanding accounting protects you (or Billy Joel) from unethical business practices? Unfortunately, if someone is determined to act unethically, they'll probably find a way. Nonetheless, becoming an informed consumer of financial and accounting information can teach you what to look for, tip you off to irregularities, and reduce your likelihood of being a victim of others' financial dishonesty or mistakes. In short, there are many good reasons to study accounting even if you don't plan to be an accountant.

Throughout this module you will learn about key financial statements, financial ratios, measures of corporate financial health, and some of the ethical issues surrounding accounting practices. By the end, you might not be a rock star, but you'll be a more informed user of financial information—without learning the hard way!

1. http://www.billyjoel.com/biography ↵

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6.2: Accounting in Business

What you'll learn to do: define accounting, and explain its role as a form of business communication

How businesses express their financial health and stability is by presenting an "accounting" of all their financial transactions. In this section you will explore in depth what accounting is and the vital information it communicates about the business.

Learning Objectives

- Identify the users and uses of financial accounting
- Identify the users and uses of managerial accounting

What Is Accounting?

Why Do we Need Financial Information?

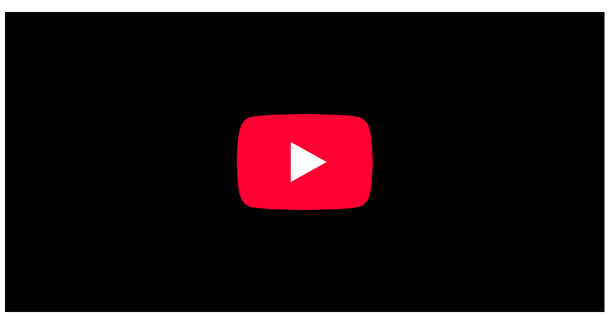
As you learned earlier in the course, businesses have large groups of stakeholders who have a vested interested in the continued success of the enterprise. If a business, whether for-profit or nonprofit, becomes financially insolvent and can't pay its bills, it will be forced to close. Financial information enables a business to track its accounts and avoid insolvency.

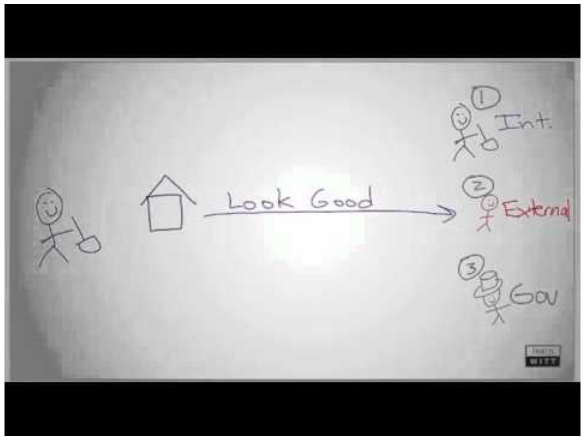
Each business needs financial information to be able to answer questions such as the following:

- How much cash does the business need to pay its bills and employees?
- Is the business profitable, earning more income than it pays in expenses, or is it losing money and possibly in danger of closing?
- How much of a particular product or mixture of products should the business produce and sell?
- What is the cost of making the goods or providing the service?
- What are the business's daily, monthly, and annual expenses?
- Do customers owe money to the business, and are they paying on time?
- How much money does the business owe to vendors (suppliers), banks, or other investors?

The video below gives a brief overview of many of the topics in this section. Before you review the video, consider these questions:

- What is accounting?
- What is business?
- Who are the three people that want to know the story of your business?
- What language of accounting does the government use?
- What language of accounting do investors use?
- What language of accounting do internal users employ?





Accounting Is the Language of Business

Every business organization that has economic resources, such as money, machinery, and buildings, uses accounting information. For this reason, accounting is called the language of business. Accounting also serves as the language providing financial information about not-for-profit organizations such as governments, churches, charities, fraternities, and hospitals. However, in this module we will focus on accounting for business firms.

The accounting process provides financial data for a broad range of individuals whose objectives in studying the data vary widely. Bank officials, for example, may study a company's financial statements to evaluate the company's ability to repay a loan. Prospective investors may compare accounting data from several companies to decide which company represents the best investment. Accounting also supplies management with significant financial data useful for decision making.

Definition of Accounting

As the video explained, accounting is "the language of business." The American Accounting Association defines **accounting** as "the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by the users of the information."

This information is primarily financial—stated in money terms. Accounting, then, is a measurement and communication process used to report on the activities of profit-seeking business organizations. As a measurement and communication process for business, accounting supplies information that permits informed judgments and decisions by users of the data.

Internal and External Users

Users of accounting information are separated into two groups, internal and external. **Internal users** are the people within a business organization who use accounting information. For example, the human resource department needs to have information about how profitable the business is in order to set salaries and benefits. Likewise, production managers need to know if the business is doing well enough to afford to replace worn-out machinery or pay overtime to production workers. **External users** are people outside the business entity that use accounting information. These external users include potential investors, the Internal Revenue Service, banks and finance companies, as well as local taxing authorities. Accounting information is valuable to both groups when it comes time to evaluate the financial consequences of various alternatives. Accountants reduce uncertainty by using professional judgment to quantify the future financial impact of taking action or delaying action. In short, although accounting information plays a significant role in reducing uncertainty within an organization, it also provides financial data for persons outside the company.

Financial accounting information appears in financial statements that are intended primarily for external use (although management also uses them for certain internal decisions). Stockholders and creditors are two of the outside parties who need financial accounting information. These outside parties decide on matters pertaining to the entire company, such as whether to increase or decrease their investment in a company or to extend credit to a company. Consequently, financial accounting information relates to the company as a whole, while managerial accounting focuses on the parts or segments of the company.

Because the external users of accounting information vary greatly, the way that financial information is presented must be consistent from year to year and company to company. In order to facilitate this, financial accountants adhere to set of rules called Generally Accepted Accounting Principles (GAAP). **GAAP** are a uniform set of accounting rules that allow users to compare the financial statements issued by one company to those of another company in the same industry. These principles for financial reporting are issued by an independent non-profit agency created by the Securities Exchange Commission (SEC) called the **Financial Accounting Standards Board (FASB)**. The FASB's mission is "to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports."

Tax accounting information includes financial accounting information, written and presented in the tax code of the government—namely the Internal Revenue Code. Tax accounting focuses on compliance with the tax code and presenting the profit and loss story of a business to minimize its tax liability.

Accounting is more than just reporting income to taxing authorities or providing revenue and expense information to potential investors. As the language of business, accounting is used for decision-making as well.

Managerial accounting information is for internal use and provides special information for the managers of a company. The information managers use may range from broad, long-range planning data to detailed explanations of why actual costs varied from cost estimates. The employees of a firm who perform these managerial accounting functions are often referred to as Cost Accountants. Managerial accounting is more concerned with forward looking projections and making decisions that will affect the future of the organization, than in the historical recording and compliance aspects of the financial accountants. There are no reporting guidelines such as GAAP; therefore, managerial accounting reports will vary widely in both scope and content. Also, much of the information generated by managerial accountants is confidential and not intended to be shared outside of the organization. Managerial accounting focus on range of topics from production planning to budgets for raw materials. When a company makes a decision to purchase a component part instead of manufacture it in house, that decision is based primarily on managerial accounting information. For this reason, many managerial accountants consider themselves to be provide "accounting information for decision making."

Bookkeeping vs. Accounting

Accounting is often confused with bookkeeping. **Bookkeeping** is a mechanical process that records the routine economic activities of a business. **Accounting** includes bookkeeping, but it goes further to analyze and interpret financial information, prepare financial statements, conduct audits, design accounting systems, prepare special business and financial studies, prepare forecasts and budgets, and provide tax services.

Importance of Accounting

You probably will find that of all the business knowledge you have acquired or will learn, the study of accounting will be the most useful. Your financial and economic decisions as a student and consumer involve accounting information. When you file income tax returns, accounting information helps determine your taxes payable.

Understanding the discipline of accounting also can influence many of your future professional decisions. You cannot escape the effects of accounting information on your personal and professional life.

6.3: Key Financial Statements

What you'll learn to do: identify key financial statements and their components, and explain the primary use of each type of statement

In this section you will learn about key financial statements of accounting: the balance sheet, income statement, statement of owner's equity, and statement of cash flows. By examining the components of each you will see the connections between the statements and be able to use this information to help you determine the point at which your business becomes profitable—the break-even point.

Learning Objectives

- Identify the use and components of the balance sheet
- Identify the use and components of the statement of owner's equity
- Explain how the balance sheet, income statement, statement of owner's equity, and statement of cash flows are connected

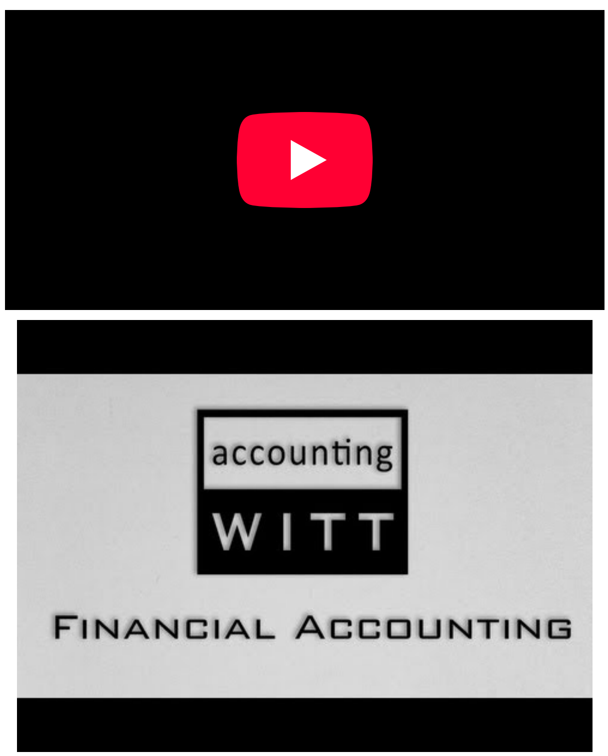
Financial Statements

Financial statements are the means by which companies communicate their story. Together these statements represent the profitability and financial strength of a company. The financial statement that reflects a company's profitability is the **income statement.** The **statement of owner's equity**—also called the **statement of retained earnings**—shows the change in retained earnings between the beginning and end of a period (e.g., a month or a year). The **balance sheet** reflects a company's solvency and financial position. The **statement of cash flows** shows the cash inflows and outflows for a company during a period of time.

Financial statements are summative reports in that they report information obtained from the day-to-day bookkeeping activities of financial accountants or bookkeepers. After all of the income and expenses of the business have been recorded, financial accountants prepare financial statements in the following order:

1. Income Statement
2. Statement of Retained Earnings—also called Statement of Owner's Equity
3. The Balance Sheet
4. The Statement of Cash Flows

The following video summarizes the four financial statements required by GAAP.



In order to get a better understanding of financial statements, what they communicate to the users of accounting information, and how the statements are connected, we will use the final balances as of January 31, 20XX for a fictitious delivery-service company, Metro Courier Inc. Just as a financial accountant would do, we will use these figures to prepare the company's financial statements required by GAAP.

Before we start, we need to define three terms and an equation that are used throughout the accounting process.

- **Asset**: An asset is an economic resource. Anything tangible or intangible that can be owned or controlled to produce value and that is held to have positive economic value is considered an asset. Simply stated, assets represent value of ownership that can be converted into cash (although cash itself is also considered an asset). Assets include things like cash, vehicles, buildings, equipment, patents, and debts owed to the company.
- **Liability**: A liability is defined as the future sacrifices of economic benefits that the entity is *obliged* to make to other entities as a result of past transactions or other *past* events, the settlement of which may result in the transfer or use of assets, provision of services, or other yielding of economic benefits in the future. Liabilities include things like loans, monies owed to suppliers or creditors that the business will use assets (i.e., cash) to settle.
- **Equity**: Equity is the difference between the value of the assets and the amount of the liabilities of something owned. Owner's equity consists of the net assets of an entity. Net assets is the difference between the total assets and total liabilities. When the owners are shareholders, the interest can be called shareholders' equity; the accounting remains the same, and it is ownership equity spread out among shareholders.

You can see that these three terms are interconnected, and their interconnection produces an equation that is at the heart of all financial accounting: **The Accounting Equation**. The accounting equation represents the relationship between assets, liabilities, and the owner's equity of a business. It's the foundation for the double-entry accounting system, accepted to be the most reliable and accurate method of recording the financial transactions of a business. The accounting equation must always "balance": The left and right side of the equation must be equal. The accounting equation is as follows:

Assets − Liabilities = Owner's or Shareholders' Equity

Now that you have a better understanding of the language of financial statements, let's look at Metro Courier's financial information and prepare some financial statements.

Balance of Accounts for Metro Courier Inc. as of January 31, 20XX

Cash	Asset	$ 66,800
Accounts Receivable	Asset	$ 5,000
Supplies	Asset	$ 500
Prepaid rent	Asset	$ 1,800
Equipment	Asset	$ 5,500
Truck	Asset	$ 8,500
Accounts Payable	Liability	$ 200
Common Stock	Equity	$ 30,000
Retained Earnings	Equity	$ 0
Service Revenue	Revenue	$ 60,000
Salary Expense	Expense	$ 900
Utilities Expense	Expense	$ 1,200

Income Statement

The **income statement,** sometimes called an earnings statement or profit and loss statement, reports the profitability of a business organization for a *stated period of time*. In accounting, we measure profitability for a period, such as a month or year, by comparing the revenues earned with the expenses incurred to produce these revenues. This is the *first* financial statement prepared, as you will need the information from this statement for the remaining statements. The income statement contains the following:

- **Revenues** are the inflows of cash resulting from the sale of products or the rendering of services to customers. We measure revenues by the prices agreed on in the exchanges in which a business delivers goods or renders services.
- **Expenses** are the costs incurred to produce revenues. Expenses are costs of doing business (typically identified as accounts ending in the word "expense").
- **Revenues – Expenses = Net Income**. Net income is often called the earnings of the company. When expenses exceed revenues, the business has a **net loss**.

Metro Courier Inc.		
Income Statement		
Month Ended January 31, 20XX		
Revenue:		
Service Revenue	$ 60,000	
Total Revenues		$ 60,000
Expenses:		
Salary Expense	900	
Utility Expense	1, 200	
Total Expenses		2,100
Net Income ($60,000 – 2,100)		**$ 57,900**

The net income from the income statement will be used in the Statement of Equity.

Statement of Retained Earnings (or Owner's Equity)

The **statement of retained earnings**, explains the changes in retained earnings between two balance sheet dates. We start with beginning retained earnings (in our example, the business began in January, so we start with a zero balance) and add any net income (or subtract net loss) from the income statement. Next, we subtract any dividends declared (or any owner withdrawals in a partnership or sole-proprietor) to get the ending balance in retained earnings (or capital for non-corporations)

Metro Courier Inc.	
Statement of Retained Earnings	
Month Ended January 31, 20XX	
Beginning Retained Earnings, Jan 1	$ 0
Net income from month (from income statement)	57,900
Total increase	$ 57,900
Dividends (or withdrawals for non-corporations)	– $0
Ending Retained Earnings, January 31	**$ 57,900**

The ending balance we calculated for retained earnings (or capital) is reported on the balance sheet.

Balance Sheet

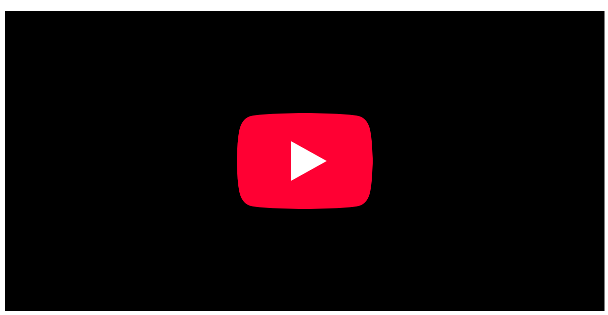
The **balance sheet** lists the company's assets, liabilities, and equity (including dollar amounts) as of a specific moment in time. That specific moment is the close of business on the date of the balance sheet. Notice how the heading of the balance sheet differs from the headings on the income statement and statement of retained earnings. A balance sheet is like a photograph; it captures the financial position of a company at a particular *moment* in time. The other two statements are for a *period* of time. As you learn about the assets, liabilities, and stockholders' equity contained in a balance sheet, you will understand why this financial statement provides information about the solvency of the business.

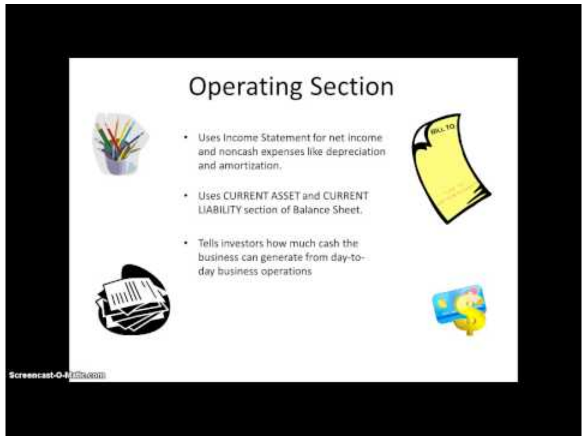
Metro Courier Inc.				
Balance Sheet				
January 31, 20XX				
Assets		**Liabilities and Equity**		
Cash	$ 66,800	Accounts Payable	200	
Accounts Receivable	5,000	**Total Liabilities**		200
Supplies	500			
Prepaid Rent	1,800	Common Stock	30,000	
Equipment	5,500	Retained Earnings	57,900	
Truck	8,500	**Total Equity**		87,900
Total Assets	**$ 88,100**	**Total Liabilities + Equity**		**$ 88,100**

You can see the accounting equation in action here on the balance sheet. The accounting equation is Assets – Liabilities = Owner's Equity. For Metro Courier Inc., this is $88,100 – $200 = $87,900.

Statement of Cash Flows

The main purpose of the statement of cash flows is to report on the cash receipts and cash disbursements of an entity during an accounting period. Broadly defined, cash includes both cash and cash equivalents, such as short-term investments in Treasury bills, commercial paper, and money market funds. Another purpose of this statement is to report on the entity's investing and financing activities for the period. The statement of cash flows reports the effects on cash during a period of a company's operating, investing, and financing activities. Firms show the effects of significant investing and financing activities that do not affect cash in a schedule separate from the statement of cash flows.





The **statement of cash flows** summarizes the effects on cash of the operating, investing, and financing activities of a company during an accounting period; it reports on past management decisions on such matters as issuance of capital stock or the sale of long-term bonds. This information is available only in bits and pieces from the other financial statements. Since cash flows are vital to a company's financial health, the statement of cash flows provides useful information to management, investors, creditors, and other interested parties.

The statement of cash flows presents the effects on cash of all significant operating, investing, and financing activities. By reviewing the statement, management can see the effects of its past major policy decisions in quantitative form. The statement may show a flow of cash from operating activities large enough to finance all projected capital needs internally rather than having to incur long-term debt or issue additional stock. Alternatively, if the company has been experiencing cash shortages, management can use the statement to determine why such shortages are occurring. Using the statement of cash flows, management may also recommend to the board of directors a reduction in dividends to conserve cash.

The statement of cash flows classifies cash receipts and disbursements as operating, investing, and financing cash flows. Both inflows and outflows are included within each category.

Operating activities generally include the cash effects (inflows and outflows) of transactions and other events that enter into the determination of net income. Cash inflows from operating activities affect items that appear on the income statement and include: (1) cash receipts from sales of goods or services; (2) interest received from making loans; (3) dividends received from investments in equity securities; (4) cash received from the sale of trading securities; and (5) other cash receipts that do not arise from transactions defined as investing or financing activities, such as amounts received to settle lawsuits, proceeds of certain insurance settlements, and cash refunds from suppliers.

Cash outflows for operating activities affect items that appear on the income statement and include payments: (1) to acquire inventory; (2) to other suppliers and employees for other goods or services; (3) to lenders and other creditors for interest; (4) for purchases of trading securities; and (5) all other cash payments that do not arise from transactions defined as investing or financing activities, such as taxes and payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

Investing activities generally include transactions involving the acquisition or disposal of noncurrent assets. Thus, cash inflows from investing activities include cash received from: (1) the sale of property, plant, and equipment; (2) the sale of available-for-sale and held-to-maturity securities; and (3) the collection of long-term loans made to others. Cash outflows for investing activities include cash paid: (1) to purchase property, plant, and equipment; (2) to purchase available-for-sale and held-to-maturity securities; and (3) to make long-term loans to others.

Financing activities generally include the cash effects (inflows and outflows) of transactions and other events involving creditors and owners. Cash inflows from financing activities include cash received from issuing capital stock and bonds, mortgages, and notes, and from other short- or long-term borrowing. Cash outflows for financing activities include payments of cash dividends or other distributions to owners (including cash paid to purchase treasury stock) and repayments of amounts borrowed. Payment of interest is not included because interest expense appears on the income statement and is, therefore, included in operating activities. Cash payments to settle accounts payable, wages payable, and income taxes payable are not financing activities. These payments are included in the operating activities section.

Information about all material investing and financing activities of an enterprise that do not result in cash receipts or disbursements during the period appear in a separate schedule, rather than in the statement of cash flows. The disclosure may be in narrative form. For instance, assume a company issued a mortgage note to acquire land and buildings.

Financial Statements: Interconnectivity

Watch the following video, and pay special attention to the interconnection between the four financial statements required by GAAP.

6.4: The Break-Even Point

What you'll learn to do: calculate the break-even point, where profit will be equal to $0, using information from financial statements

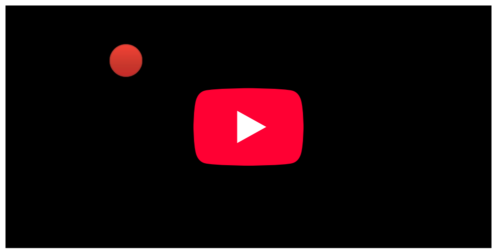
In this section you will learn to calculate the point where the amount of income you earn results in neither a profit nor a loss—and "breaks even."

Learning Objectives

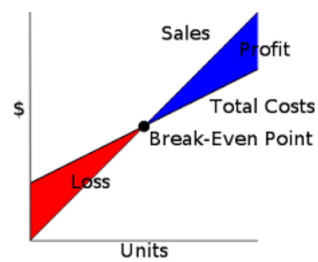
- Differentiate between fixed and variable costs
- Calculate the contribution margin
- Calculate the margin of safety

Finding the Break-Even Point

When can you say a business is good or not? Watch the following video to find out.



The Break-Even Point



A company breaks even for a given period when sales revenue and costs incurred during that period are equal. Thus the **break-even point** is that level of operations at which a company realizes no net income or loss.

A company may express a break-even point in dollars of sales revenue or number of units produced or sold. No matter how a company expresses its break-even point, it is still the point of zero income or loss.

In order to grasp the concept of breakeven, it's important to understand that all costs are not created equal: Some are fixed, and some are variable. **Fixed Costs** are expenses that are not dependent on the amount of goods or services produced by the business. They are things such as salaries or rents paid per month. If you own a car, then your car payment and insurance premiums are fixed costs because you pay them every month whether you drive your car or not. **Variable Costs** are volume related and are paid per quantity or unit produced. For your car, your variable costs are things like gas, maintenance, or tires because you only incur these costs when you drive your car. The more miles you drive, the more your gas expenses go up—such costs vary with the level of activity.

Before we turn to the calculation of the break-even point, it's also important to understand contribution margin.

Contribution Margin

Contribution margin is the portion of revenue that is not consumed by variable cost. In a simple example, if you were to buy a candy bar for 75 cents and resell it for $1, then the contribution margin would be 25 cents—the amount not consumed by cost.

Of course, in business this is generally more complicated. It requires you to understand the variable costs for an item, or those costs that are directly tied to producing a new unit. When selling lemonade from a stand, the costs of the water, lemon juice, sweetener, ice, and serving glass are all variable costs that will recur with each item sold. The cost of the stand is a fixed cost. The labor required to make and serve the lemonade is also generally a fixed cost, as it doesn't vary based on the number of glasses sold. Let's look at this in numeric terms, as follows:

Inputs	Cost	Category
Lemons, sweetener, ice, and water	20 cents per glass	Variable
Glasses	5 cents each	Variable
Labor	$100 per day per employee	Fixed

Inputs	Cost	Category
Lemonade stand rental	$2,000 per month	Fixed

If we know that the stand sells 1,000 glasses of lemonade each day at $3 per glass, and that one employee can make and serve 1,000 glasses, then we can calculate the contribution margin.

The cost of raw materials is 25 cents per glass (20 for ingredients + 5 for the glass). If the lemonade is sold for $3 per glass, then the contribution margin is $2.75 per glass.

It's important to know the contribution margin in order to calculate what portion of the revenue from a product is consumed by the variable costs and what portion can be used to cover, or contribute to, fixed costs.

Breakeven in Units

To illustrate the calculation of a break-even point in units, Video Productions produces videotapes selling for USD 20 per unit. Fixed costs per period total USD 40,000, while the variable cost is USD 12 per unit.

We compute the break-even point in units by dividing total fixed costs by the contribution margin per unit. The contribution margin per unit is USD 8 (USD 20 selling price per unit – USD 12 variable cost per unit). In the following break-even equation, BE refers to the break-even point:

$$BE\,units = \frac{Fixed\ costs}{Contribution\ margin\ per\ unit}$$

$$BE\,units = \frac{USD\ 40{,}000}{8\ per\ unit}$$

$$BE\,units\ = 5,000\,units$$

The result tells us that Video Productions breaks even at a volume of 5,000 units per month. We can prove that to be true by computing the revenue and total costs at a volume of 5,000 units. Revenue = 5,000 units X USD 20 sales price per unit = USD 100,000. Total costs = USD 100,000 = USD 40,000 fixed costs + USD 60,000 variable costs (USD 60,000 = USD 12 per unit X 5,000 units).

Note that the revenue and total cost lines cross at 5,000 units—the break-even point. Video Productions has net income at volumes greater than 5,000, but it has losses at volumes less than 5,000 units.

Breakeven in Sales Dollars

Companies frequently measure volume in terms of sales dollars instead of units. For a company such as General Motors that makes not only automobiles but also small components sold to other manufacturers and industries, it makes no sense to think of a break-even point in units. General Motors evaluates breakeven in sales dollars.

The formula to compute the break-even point in sales dollars looks a lot like the formula to compute the breakeven in units, except we divide fixed costs by the contribution margin ratio instead of the contribution margin per unit.

$$BE\,units = \frac{Fixed\ costs}{Contribution\ margin\ ration}$$

A Broader Perspective: Even Colleges Use Breakeven

The dean of the business school at a particular university was considering whether to offer a seminar for executives. The tuition would be USD 650 per person. Variable costs, including meals, parking, and materials, would be USD 80 per person. Certain costs of offering the seminar, including advertising, instructors' fees, room rent, and audiovisual equipment rent, would not be affected by the number of people attending. Such seminar costs, which could be thought of as fixed costs, amounted to USD 8,000.

In addition to these costs, a number of staff, including the dean, would work on the program. Although the salaries paid to these staff were not affected by offering the seminar, working on it took these people away from other duties, thus creating an opportunity cost, estimated to be USD 7,000 for this seminar.

Given this information, the school estimated the break-even point to be (USD 8,000 + USD 7,000)/(USD 650 – USD 80) = 26.3 students. If the school wanted at least to break even on this program, it should offer the program only if it expected at least 27 students to attend.

Contribution Margin Ratio

The contribution margin ratio expresses the contribution margin as a percentage of sales. To calculate this ratio, divide the contribution margin per unit by the selling price per unit, or total contribution margin by total revenues. Video Production's contribution margin ratio is:

$$Contribution\,margin\,ratio = \frac{Contribution\ margin\ per\ unit}{Selling\,price\,per\,unit}$$

$$\frac{USD\ 20 - USD\ 12}{USD\ 20} = \frac{USD\ 8}{USD\ 20} = 0.40$$

Supposing that Video Productions had a total contribution margin of USD 48,000 on revenues of USD 120,000, we compute the contribution margin ratio as follows:

$$Contribution\,margin\,ratio = \frac{Total\ contribution\ margin}{Total\ revenues}$$

$$\frac{USD\ 48{,}000}{USD\ 120{,}000} = 0.40$$

That is, for each dollar of sales, there is a USD 0.40 contribution to covering fixed costs and generating net income.

Using this ratio, we calculate Video Production's break-even point in sales dollars as:

$$BE\,units = \frac{Fixed\ costs}{Contribution\ margin\ rate}$$

$BE\,dollars = \frac{USD\ 40{,}000}{0.40} = USD\,100,000$

The break-even volume of sales is USD 100,000 (5,000 units at USD 20 per unit). At this level of sales, fixed costs plus variable costs equal sales revenue.

In a period of complete idleness (no units produced), Video Productions would lose USD 40,000 (the amount of fixed costs). However, when Video Productions has an output of 10,000 units, the company has net income of USD 40,000.

Although you are likely to use break-even analysis for a single product, you will more frequently use it in multi-product situations. The easiest way to use break-even analysis for a multi-product company is to use dollars of sales as the volume measure. For break-even analysis purposes, a multi-product company must assume a given product mix. **Product mix** refers to the proportion of the company's total sales attributable to each type of product sold.

To illustrate the computation of the break-even point for Wonderfood, a multi-product company that makes three types of cereal, assume the following historical data:

Product								
	1		2		3		Total	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Sales	$60,000	100%	$30,000	100%	$10,000	100%	$100,000	100%
Less:								
Variable costs	40,000	67%	16,000	53%	4,000	40%	60,000	60%
Contribution margin	$20,000	33%	$14,000	47%	$ 6,000	60%	$ 40,000	40%

We use the data in the total columns to compute the break-even point. The contribution margin ratio is 40 percent or (USD 40,000/USD 100,000). Assuming the product mix remains constant and fixed costs for the company are USD 50,000, break-even sales are USD 125,000, computed as follows:

$BE\,units = \frac{Fixed\ costs}{Contribution\ margin\ ratio}$

$BE\,dollars = \frac{USD\ 50{,}000}{0.40} = USD\,125,000$

[To check our answer: (USD 125,000 X 0.40) – USD 50,000 = USD 0.]

To find the three product sales totals, we multiply total sales dollars by the percent of product mix for each of the three products. The product mix for products 1, 2, and 3 is 60:30:10, respectively. That is, out of the USD 100,000 total sales, there were sales of USD 60,000 for product 1, USD 30,000 for product 2, and USD 10,000 for product 3. Therefore, the company has to sell USD 75,000 of product 1 (0.6 X USD 125,000), USD 37,500 of product 2 (0.3 X USD 125,000), and USD 12,500 of product 3 (0.1 X USD 125,000) to break even.

an accounting perspective: business insight

The founder of Domino's Pizza, Inc. nearly went bankrupt several times before he finally made Domino's a financial success. One early problem was that the company was providing small pizzas that cost almost as much to make and just as much to deliver as larger pizzas. Because they were small, the company could not charge enough to cover its costs. At one point, the company's founder was so busy producing small pizzas that he did not have time to determine that the company was losing money on them.

Margin of Safety

If a company's current sales are more than its break-even point, it has a margin of safety equal to current sales minus break-even sales. The **margin of safety** is the amount by which sales can decrease before the company incurs a loss. For example, assume Video Productions currently has sales of USD 120,000 and its break-even sales are USD 100,000. The margin of safety is USD 20,000, computed as follows:

Margin safety = Current sales – Break-even sales

= USD 120,000 – USD 100,000

= USD 20,000

Sometimes people express the margin of safety as a percentage, called the margin of safety rate. The **margin of safety rate** is equal to $\frac{Current\ sales - Break{-}even\ sales}{Current\ sales}$. Using the data just presented, we compute the margin of safety rate as follows:

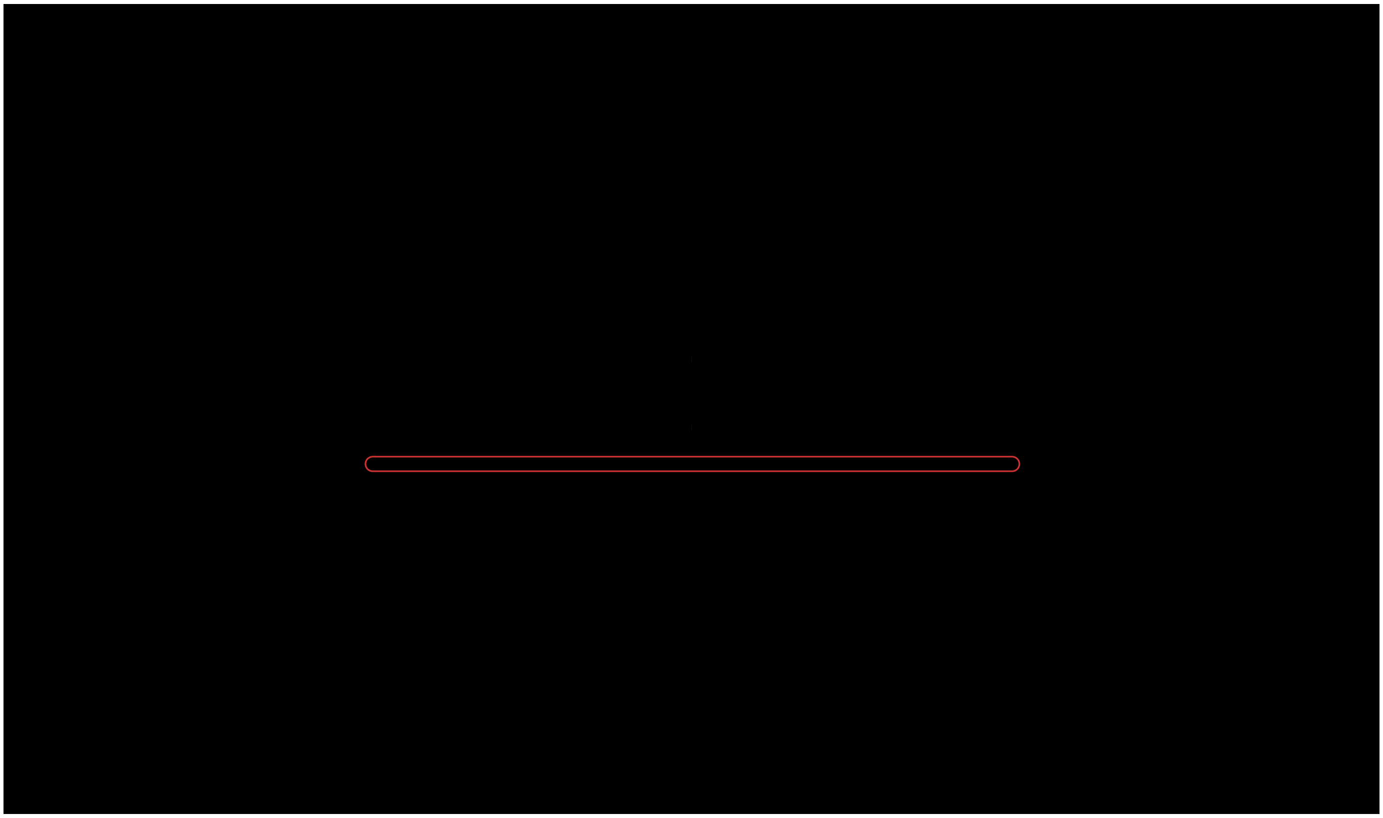
$Margin\,of\,safety\,rate = \frac{Current\ sales - Break{-}even\ sales}{Current\ sales}$

$\frac{USD\ 120{,}000 - USD\ 100{,}000}{USD\ 12{,}000} = 16.67\%$

This means that sales volume could drop by 16.67 percent before the company would incur a loss.

Try It

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



6.5: Financial Ratios

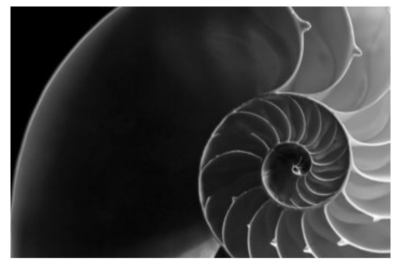
What you'll learn to do: use financial statements to calculate basic financial ratios to measure the profitability and health of a business

Financial ratios allow consumers of financial information to compare how companies are doing relative to their industry or even how they are faring from one period (month, quarter, year) to another. For the purposes of this course, you will be working with just a couple of these ratios—namely liquidity and profitability. There are lots of other financial ratios, but you can save those for a time when you take full courses in finance and accounting.

Learning Objectives

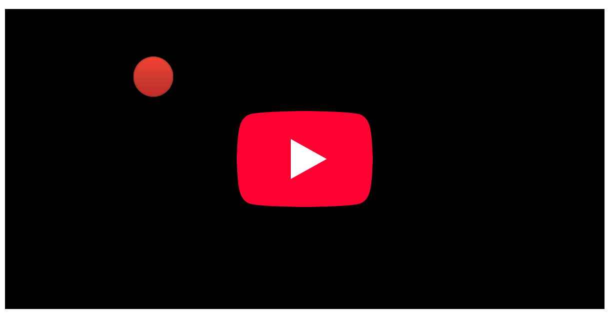
- Calculate the current ratio using information from financial statements
- Calculate inventory turnover using information from financial statements

Financial Ratio Analysis



Financial ratios allow us to look at profitability, use of assets, inventories, and other assets, liabilities, and costs associated with the finances of the business. We can also use them to learn how quickly people pay their bills, how long it takes the company to recover its costs for new equipment, how much cash the company has relative to its debt, and its return (profit) on every dollar the company invests. Financial ratios also enable a company to compare itself to other firms in the same industry and answer questions like "Are the other dog biscuit companies doing about the same as ours?"

Sometimes it's not enough to say that a company is in good or bad financial health, especially if you're trying to compare that company with another one. To make comparisons easier, it helps to assign numbers to "health." The following video explains how that can be done.



Logical relationships exist between certain accounts or items in a company's financial statements. These accounts may appear on the same statement or on two different statements. We set up the dollar amounts of the related accounts or items in fraction form called ratios. These ratios include the following:

Ratio	Use	Components
Liquidity ratio	indicate a company's short-term debt-paying ability	**current (or working capital) ratio; acid-test (quick) ratio;** cash flow liquidity ratio; accounts receivable turnover; number of day's sales in accounts receivable; **inventory turnover**; and total assets turnover
Equity (long-term solvency) ratio	show the relationship between debt and equity financing in a company	equity (or stockholders' equity) ratio; and stockholders' equity to debt ratio
Profitability test	an important measure of a company's operating success	rate of return on operating assets; net income to net sales; net income to average common stockholders' equity; cash flow margin; earnings per share of common stock; times interest earned ratio; and times preferred dividends earned ratio
Market test	help investors and potential investors assess the relative merits of the various stocks in the marketplace	earnings yield on common stock; price-earnings ratio; dividend yield on common stock; payout ratio on common stock; dividend yield on preferred stock; and cash flow per share of common stock

Many of these ratios are beyond the scope of this course; however, we will examine the ones in bold, above, which are key to evaluating any business.

Current (or Working Capital) Ratio

Working capital is the excess of current assets over current liabilities. The ratio that relates current assets to current liabilities is the **current (or working capital) ratio**. The current ratio indicates the ability of a company to pay its current liabilities from current assets, and thus shows the strength of the company's working capital position.

You can compute the current ratio by dividing current assets by current liabilities, as follows:

$Current\ ratio = \frac{Current\ assets}{Current\ liabilities}$

The ratio is usually stated as a number of dollars of current assets to one dollar of current liabilities (although the dollar signs usually are omitted). Thus, for Synotech in 2010, when current assets totaled USD 2,846.7 million and current liabilities totaled USD 2,285.2 million, the ratio is 1.25:1, meaning that the company has USD 1.25 of current assets for each USD 1.00 of current liabilities.

The current ratio provides a better index of a company's ability to pay current debts than does the absolute amount of working capital. To illustrate, assume that we are comparing Synotech to Company B. For this example, use the following totals for current assets and current liabilities:

	Synotech	**Company B**
Current assets (a)	$ 2,846.7	$120.0
Current liabilities (b)	2,285.2	53.2
Working capital (a – b)	$ 561.5	$ 66.8
Current ratio (a/b)	1.25:1	2.26:1

Synotech has eight times as much working capital as Company B. However, Company B has a superior debt-paying ability since it has USD 2.26 of current assets for each USD 1.00 of current liabilities.

Short-term creditors are particularly interested in the current ratio since the conversion of inventories and accounts receivable into cash is the primary source from which the company obtains the cash to pay short-term creditors. Long-term creditors are also interested in the current ratio because a company that is unable to pay short-term debts may be forced into bankruptcy. For this reason, many bond indentures, or contracts, contain a provision requiring that the borrower maintain at least a certain minimum current ratio. A company can increase its current ratio by issuing long-term debt or capital stock or by selling noncurrent assets.

A company must guard against a current ratio that is too high, especially if caused by idle cash, slow-paying customers, and/or slow-moving inventory. Decreased net income can result when too much capital that could be used profitably elsewhere is tied up in current assets.

Acid-Test (Quick) Ratio

The current ratio is not the only measure of a company's short-term debt-paying ability. Another measure, called the **acid-test (quick) ratio**, is the ratio of quick assets (cash, marketable securities, and net receivables) to current liabilities. The formula for the acid-test ratio is the following:

$$Acid\,test\,ratio = \frac{Quick\,assets}{Current\,liabilities}$$

Short-term creditors are particularly interested in this ratio, which relates the pool of cash and immediate cash inflows to immediate cash outflows.

The acid-test ratios for 2010 and 2009 for Synotech follow:

December 31			
(USD millions)	**2010**	**2009**	**Amount of increase or (decrease)**
Quick assets (a)	$1,646.6	$1,648.3	$ (1.7)
Current liabilities (b)	2,285.6	2,103.8	181.8
Net quick assets (a – b)	$ (639.0)	$ (455.5)	$(183.5)
Acid-test ratio (a/b)	.72:1	.78:1	

In deciding whether the acid-test ratio is satisfactory, investors consider the quality of the marketable securities and receivables. An accumulation of poor-quality marketable securities or receivables, or both, could cause an acid-test ratio to appear deceptively favorable. When referring to marketable securities, poor quality means securities likely to generate losses when sold. Poor-quality receivables may be uncollectible or not collectible until long past due. The quality of receivables depends primarily on their age, which can be assessed by preparing an aging schedule or by calculating the accounts receivable turnover.

Inventory Turnover

A company's inventory turnover ratio shows the number of times its average inventory is sold during a period. You can calculate **inventory turnover** as follows:

$$Inventory\,turnover = \frac{Cost\,of\,goods\,sold}{Average\,inventory}$$

When comparing an income statement item and a balance sheet item, we measure both in comparable dollars. Notice that we measure the numerator and denominator in cost rather than sales dollars. Inventory turnover relates a measure of sales volume to the average amount of goods on hand to produce this sales volume.

Synotech's inventory on 2009 January 1, was USD 856.7 million. The following schedule shows that the inventory turnover decreased slightly from 5.85 times per year in 2009 to 5.76 times per year in 2010. To convert these turnover ratios to the number of days it takes the company to sell its entire stock of inventory, divide 365 by the inventory turnover. Synotech's average inventory sold in about 63 and 62 (365/5.76 and 365/5.85) in 2010 and 2009, respectively.

December 31			
(USD millions)	**2010**	**2009**	**Amount of increase or (decrease)**

Cost of goods sold (a)	$5,341.3	$5,223.7	$117.6
Merchandise inventory:			
January 1	$929.8	$856.7	$ 73.1
December 31	924.8	929.8	(5.0)
Total (b)	$1,854.6	$1,786.5	$ 68.1
Average inventory (c) (b/2 = c)	$927.3	$893.3	
Turnover of inventory (a/c)	5.76	5.85	

Other things being equal, a manager who maintains the *highest* inventory turnover ratio is the most efficient. Yet, other things are not always equal. For example, a company that achieves a high inventory turnover ratio by keeping extremely small inventories on hand may incur larger ordering costs, lose quantity discounts, and lose sales due to lack of adequate inventory. In attempting to earn satisfactory income, management must balance the costs of inventory storage and obsolescence and the cost of tying up funds in inventory against possible losses of sales and other costs associated with keeping too little inventory on hand.

Standing alone, a single financial ratio may not be informative. Investors gain greater insight by computing and analyzing several related ratios for a company. Financial analysis relies heavily on informed judgment. As guides to aid comparison, percentages and ratios are useful in uncovering potential strengths and weaknesses. However, the financial analyst should seek the basic causes behind changes and established trends.

Summary of Ratios

Liquidity Ratios	**Formula**	**Significance**
Current (or working capital) ratio	Current assets / Current liabilities	Test of debt-paying ability
Acid-test (quick) ratio	Quick assets (cash + marketable securities + net receivables) / Current liabilities	Test of immediate debt-paying ability
Inventory turnover	Cost of goods sold / Average inventory	Test of whether or not a sufficient volume of business is being generated relative to inventory

Interpretation and Use of Ratios

Analysts must be sure that their comparisons are valid—especially when the comparisons are of items for different periods or different companies. They must follow consistent accounting practices if valid interperiod comparisons are to be made.

Also, when comparing a company’s ratios to industry averages provided by an external source such as Dun & Bradstreet, the analyst should calculate the company’s ratios in the same manner as the reporting service. Thus, if Dun & Bradstreet uses net sales (rather than cost of goods sold) to compute inventory turnover, so should the analyst.

Facts and conditions not disclosed by the financial statements may, however, affect their interpretation. A single important event may have been largely responsible for a given relationship. For example, competitors may put a new product on the market, making it necessary for the company to reduce the selling price of a product suddenly rendered obsolete. Such an event would severely affect net sales or profitability, but there might be little chance that such an event would happen again.

Analysts must consider general business conditions within the industry of the company under study. A corporation’s downward trend in earnings, for example, is less alarming if the industry trend or the general economic trend is also downward.

Investors also need to consider the seasonal nature of some businesses. If the balance sheet date represents the seasonal peak in the volume of business, for example, the ratio of current assets to current liabilities may be much lower than if the balance sheet date is in a season of low activity.

Potential investors should consider the market risk associated with the prospective investment. They can determine market risk by comparing the changes in the price of a stock in relation to the changes in the average price of all stocks.

Potential investors should realize that acquiring the ability to make informed judgments is a long process and does not occur overnight. Using ratios and percentages without considering the underlying causes may lead to incorrect conclusions.

Even within an industry, variations may exist. Acceptable current ratios, gross margin percentages, debt to equity ratios, and other relationships vary widely depending on unique conditions within an industry. Therefore, it is important to know the industry to make comparisons that have real meaning.

Demonstration Problem

The balance sheet and supplementary data for Xerox Corporation follow:

Xerox Corporation Balance Sheet 20XX December 31(USD millions)

	20XX
Assets	
Cash	$ 1,741
Accounts receivable, net	2,281
Finance receivables, net	5,097
Inventories	1,932
Deferred taxes and other current assets	1,971
Total current assets	$ 13,022
Finance receivables due after one year, net	7,957
Land, buildings, and equipment, net	2,495
Investments in affiliates, at equity	1,362
Goodwill	1,578
Other assets	3,061
Total assets	$ 29,475
Liabilities and stockholders' equity	
Short-term debt and current portion of long-term debt	$ 2,693
Accounts payable	1,033
Accrued compensation and benefit costs	662
Unearned income	250
Other current liabilities	1,630
Total current liabilities	$ 6,268
Long-term debt	15,404
Liabilities for post-retirement medical benefits	1,197
Deferred taxes and other liabilities	1,876
Discontinued policyholders' deposits and other operations liabilities	670
Deferred ESOP benefits	(221)
Minorities' interests in equity of subsidiaries	141
Preferred stock	647

Common shareholders' equity (108.1 million)	3,493
Total liabilities and shareholders' equity	$ 29,475

- Cost of goods sold, USD 6,197.
- Net sales, USD 18,701.
- Inventory, January 1, USD 2,290.
- Net interest expense, USD 1,031.
- Net income before interest and taxes, USD 647.
- Net accounts receivable on January 1, USD 2,633.
- Total assets on January 1, USD 28,531.

Compute the following ratios:

1. Current ratio.
2. Acid-test ratio.
3. Inventory turnover.

Solution to Demonstration Problem

1. Current ratio: $\frac{Current\ Assets}{Current\ liabilities}=\frac{USD\ 13{,}022{,}000{,}000}{USD\ 6{,}268{,}000{,}000}=2.08:1$
2. Acid-test ratio: $\frac{Quick\ Assets}{Quick\ liabilities}=\frac{USD\ 9{,}119{,}000{,}000}{USD\ 6{,}268{,}000{,}000}=1.45:1$
3. Inventory turnover: $\frac{Net\ sales}{Average\ Inventory}=\frac{USD\ 18{,}701{,}000{,}000}{USD\ 2{,}111{,}000{,}000}=8.86\ times$

2,111 million is the average of 2,290 and 1,932 mm, the inventories at the beginning and end of the year.

6.6: Ethical Practices in Accounting

What you'll learn to do: discuss the importance of ethical practices in accounting and the implications of unethical behavior

In this section you'll learn why ethical accounting practices are so important and what happens when they *aren't ethical.*

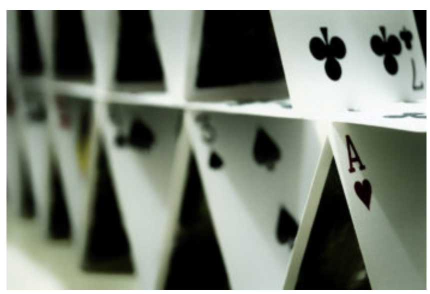
> **Learning Objectives**
>
> - Discuss the impact of the Sarbanes-Oxley Act on accounting practices

Ethics in Accounting

Due to a series of recent corporate collapses, attention has been drawn to ethical standards within the accounting profession. These collapses have caused a widespread disregard for the reputation of the accounting profession. To combat the criticism and prevent unethical and fraudulent accounting practices, various accounting organizations and governments have developed regulations and guidelines aimed at improved ethics within the accounting profession.

The following video is just one example of the type of activities that have brought the accounting profession under fire for what can best be described as questionable business practices.

Why Should an Accountant Be Ethical?



Throughout this module you have read about the wide range of people and institutions that rely on accurate accounting information to make important decisions. Despite the best efforts of FASB and GAAP, accountants and accounting firms have become increasingly "creative" in reporting the financial position of businesses and in some cases have committed outright fraud. The consequences of unethical practices in financial reporting have cost taxpayers billions of dollars, employees their jobs, and the accounting profession its untarnished reputation. Unfortunately, despite efforts by professional organizations like the AICPA and legislation by the U.S. Federal Government, there is still a subset of the accounting profession that places profit before ethics.

The **AICPA Code of Professional Conduct** is a collection of codified statements issued by the American Institute of Certified Public Accountants that outline a CPA's ethical and professional responsibilities. The code establishes standards for auditor independence, integrity and objectivity, responsibilities to clients and colleagues and acts discr to the accounting profession. Unfortunately, the opening principle of the code is that membership, and therefore adherence, to the code is voluntary. This means that an accountant is never under a legal responsibility to adhere to the code and can renounce the code and membership in the AICPA at any time.

The Sarbanes-Oxley Act

Sarbanes-Oxley (SOX) was named after sponsors U.S. Senator Paul Sarbanes and U.S. Representative Michael G. Oxley. President George W. Bush signed it into law, stating that it included "the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt. The era of low standards and false profits is over; no boardroom in America is above or beyond the law."

The bill, which contains eleven sections, was enacted as a reaction to a number of major corporate and accounting scandals, including those affecting Enron, Tyco International, Adelphia, Peregrine Systems, and WorldCom. These scandals cost investors billions of dollars when the share prices of affected companies collapsed, and shook public confidence in the U.S. securities markets.The sections of the bill cover responsibilities of a public corporation's board of directors, adds criminal penalties for certain misconduct, and required the Securities and Exchange Commission to create regulations to define how public corporations are to comply with the law.

As a result of SOX, top management must individually certify the accuracy of financial information. In addition, penalties for fraudulent financial activity are much more severe. Also, SOX increased the oversight role of boards of directors and the independence of the outside auditors who review the accuracy of corporate financial statements. The Sarbanes-Oxley Act has been cited as a positive influence on the accounting profession for nurturing an ethical culture as it forces top management to be transparent and employees to be responsible for their acts whilst protecting whistleblowers. SOX has also been praised by a cross-section of financial industry experts, citing improved investor confidence and more accurate, reliable financial statements. The CEO and CFO are now required to unequivocally take ownership for their financial statements under Section 302, which was not the case prior to SOX.

As in any area of business, ethical practices are "good business," but when individuals place their personal interests or wealth above those of the stakeholders, the consequences can be far reaching. It is only through the adherence to ethical reporting and GAAP that the accounting profession can regain the respect and prestige the profession once had and deserves.

CHAPTER OVERVIEW

7: Operations

7.1: Operations Management in Manufacturing
7.2: Operations Management in Service Industry
7.3: Quality and Operations Management

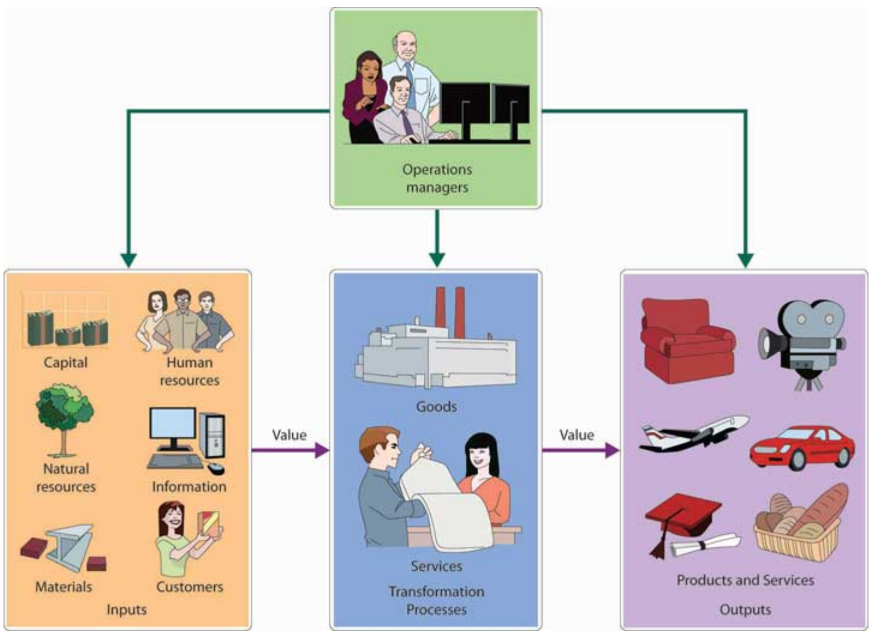
7.1: Operations Management in Manufacturing

Learning Objectives

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 11.1 “The Transformation Process” illustrates this traditional function of operations management.

Figure 11.1 The Transformation Process



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.

7.2: Operations Management in Service Industry

Learning Objectives

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 (The Global Language Monitor, 2010; Strauss, 2010). Most of us now hold jobs in the service sector, which accounts for 77 percent of U.S. gross domestic product (International Monetary Fund, 2010; Wikipedia, 2011). 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 (24/7 Wall Street, 2011).

Figure 11.9

Wal-Mart employs more than a million people in the United States.

Mike Mozart – Walmart – CC BY 2.0.

7.3: Quality and Operations Management

Learning Objective

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" (American Society of Quality, 2011). 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.

CHAPTER OVERVIEW

8: Human Resources

8.1: Human Resources and Law

8.2: Human Resource Management

8.3: Recruitment and Hiring

8.1: Human Resources and Law

What you'll learn to do: summarize and discuss key laws affecting human resource management

Federal and state legislation have a big impact on businesses. There is an important body of anti-discrimination and labor laws that have a particular effect on human resource management. You'll learn about those laws here.

Learning Objectives

- Summarize key anti-discrimination legislation
- Discuss key laws affecting human resource management

Employment Legislation

President Lyndon Johnson shakes hands with Martin Luther King Jr. after presenting him with one of the pens used to sign the Civil Rights Act of 1964.

What happens when businesses make decisions that violate laws and regulations designed to protect working Americans? In some cases it costs businesses a great deal of money. Consider the following headlines:

- South San Francisco Walgreens fired longtime employee with diabetes over a $1.39 bag of chips, federal agency charged.[1] The cost to Walgreens? $180,000.
- United Airlines pays $850,000 to a class of current and former employees with disabilities who were denied employment opportunities at San Francisco International Airport.[2]
- A Domino's franchisee agreed to pay 61 delivery employees $1.28 million to settle a wage-and-hour lawsuit.[3]

In other cases, the monetary damage may be minimal, but the reputation of the business as a "great place to work" becomes tarnished, and HR professionals have a difficult time recruiting and retaining quality employees. Businesses that disregard worker protections may find themselves on a list of "worst places to work." Such is the case with the retail clothing store Forever 21.

24/7 Wall St., a financial news service, analyzed thousands of employee reviews from jobs-and-career Web site Glassdoor. Based on employee reviews of more than 540,000 companies, the worst U.S. company were Family Dollar Stores, Express Scripts, and Forever 21.[4]

Regarding Forever 21, this year's report found the following:

> *"Over the years, the store has been hit with several high-profile lawsuits, including several filed by employees. In 2012, five Forever 21 employees filed a class-action lawsuit against the company. The plaintiffs claimed that they and their coworkers were routinely detained in the store during lunch breaks and after their shifts without overtime pay so managers could search their bags for stolen merchandise—a part of the company's former loss-prevention policy. Indeed, many employees on Glassdoor complain of not getting to leave the store until 2:00 a.m. or later, hours after the stores close, often receiving no overtime pay for the extra hours.[5]"*

Anti-Discrimination Legislation

Protecting workers against unfair treatment is at the heart of U.S. anti-discrimination legislation. In 1964, the United States Congress passed the first Civil Rights Act. In 1963 when the legislation was introduced, the act **only** forbade discrimination on the basis of sex and race in hiring, promoting, and firing. However, by the time the legislation was finally passed on July 2, 1964, Section 703 (a) made it unlawful for an employer to "fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions or privileges or employment, because of such individual's race, color, religion, sex, or national origin."

Over the years, amendments to the original act have expanded the scope of the law, and today the Equal Employment Opportunity Commission (discussed below) enforces laws that prohibit discrimination based on an *expanded* list of protected classes that includes disability, veteran status, citizenship, familial status, and age. Anti-discriminations laws today apply not only to hiring, promoting, and firing but also to wage setting, testing, training, apprenticeships, and any other terms or conditions of employment.

While the Civil Rights Act of 1964 did not mention the words *affirmative action*, it did authorize the bureaucracy to makes rules to help end discrimination. **Affirmative action** "refers to both mandatory and voluntary programs intended to affirm the civil rights of designated classes of individuals by taking positive action to protect them" from discrimination. The first federal policy of race-conscious affirmative action emerged in 1967 and required government contractors to set "goals and timetables" for integrating and diversifying their workforce. Similar policies began to emerge through a mix of voluntary practices and federal and state policies in employment and education. These include government-mandated, government-sanctioned, and voluntary private programs that tend to focus on access to education and employment, specifically granting special consideration to historically excluded groups such as racial minorities or women. The impetus toward affirmative action is redressing the disadvantages associated with past and present discrimination. A further impetus is the desire to ensure that public institutions, such as universities, hospitals, and police forces, are more representative of the populations they serve.

In the United States, affirmative action tends to emphasize not specific quotas but rather "targeted goals" to address past discrimination in a particular institution or in broader society through "good-faith efforts . . . to identify, select, and train potentially qualified minorities and women." For example, many higher education institutions have voluntarily adopted policies that seek to increase recruitment of racial minorities. Another example is executive orders requiring some government contractors and subcontractors to adopt equal opportunity employment measures, such as outreach campaigns, targeted recruitment, employee and management development, and employee support programs.

Title VII of the act created the **Equal Employment Opportunity Commission (EEOC)** to implement the law and subsequent legislation has expanded the role of the EEOC. The EEOC, as an independent regulatory body, plays a major role in dealing with the issue of employment discrimination. Since its creation in 1964, Congress has gradually extended EEOC powers to include investigatory authority, creating conciliation programs, filing lawsuits, and conducting voluntary assistance programs.

Today the regulatory authority of the EEOC includes enforcing a range of federal statutes prohibiting employment discrimination, including the following:

- **Civil Rights Act of 1964**, which prohibits employment discrimination on the basis of race, color, religion, sex, or national origin. The prohibition against **sexual harassment** falls under Title VII of this act. As defined by the EEOC, "It is unlawful to harass a person (an applicant or employee) because of that person's sex." Harassment can include "sexual harassment" or unwelcome sexual advances, requests for sexual favors, and other verbal or physical harassment of a sexual nature.
- **Age Discrimination in Employment Act (ADEA) of 1967**, and its amendments, which prohibits employment discrimination against individuals 40 years of age or older. The ADEA's protections apply to both employees and job applicants. Under the ADEA, it is unlawful to discriminate against a person because of his/her age with respect to any term, condition, or privilege of employment, including hiring, firing, promotion, layoff, compensation, benefits, job assignments, and training. The ADEA permits employers to favor older workers based on age even when doing so adversely affects a younger worker who is 40 or older.
- **Equal Pay Act (EPE) of 1963**, which prohibits discrimination on the basis of gender in compensation for substantially similar work under similar conditions. In essence, men and women doing equal jobs must receive the same pay. According to the Bureau of Labor Statistics, women's salaries vis-à-vis men's have risen dramatically since the EPA's enactment, from 62 percent of men's earnings in 1970 to 83 percent in 2014. Nonetheless, the EPA's equal pay for equal work goals have not been completely achieved.
- **Americans with Disabilities Act (ADA) of 1990**, which prohibits employment discrimination on the basis of disability in both the public and private sector, excluding the federal government. The ADA also requires covered employers to provide reasonable accommodations to employees with disabilities and imposes accessibility requirements on public accommodations. "A reasonable accommodation" is defined by the U.S. Department of Justice as "any modification or adjustment to a job or the work environment that will enable a qualified applicant or employee with a disability to participate in the application process or to perform essential job functions.
- **Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA)**, which protects the civilian employment of active and reserve military personnel in the United States called to active duty. The law applies to all United States uniformed services and their respective reserve components.

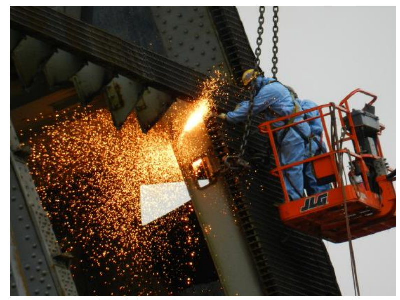
These laws were enacted to protect the average working citizen, but the existence of laws doesn't guarantee that employers will follow them. EEOC acts as a watchdog organization and steps in to assist employees who believe they have suffered workplace discrimination. Just how often do employees turn to the EEOC?

In fiscal year 2014, the EEOC received 88,778 charges of workplace discrimination. During that time, the percentage of charges alleging retaliation reached the highest level ever: 42.8 percent. The percentage of charges alleging race discrimination—the second most common allegation—has remained steady at approximately 35 percent. In fiscal year 2014, the EEOC collected $296.1 million in total monetary relief through its enforcement program prior to filing lawsuits. The number of lawsuits filed by the EEOC's Office of General Counsel throughout the nation was 133, up slightly from the previous two fiscal years. Monetary relief from cases litigated, including settlements, totaled $22.5 million.

"Behind these numbers are individuals who turned to the EEOC because they believe that they have suffered unlawful discrimination," said EEOC Chair Jenny R. Yang. "The EEOC remains committed to meaningful resolution of charges and strategic enforcement to eliminate barriers to equal employment opportunity."[6]

Labor and Safety Legislation

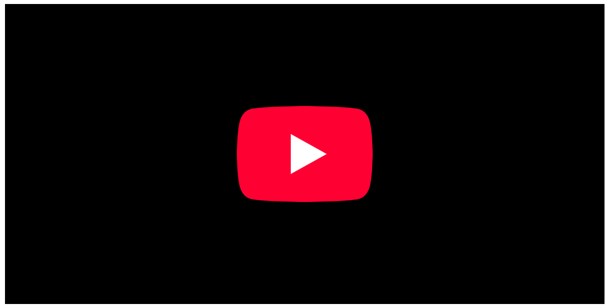
There are many other laws designed to regulate the employer-employee relationship. Several are described below:



- **National Labor Relations Act of 1935**, which created collective bargaining in labor-management relations and limited the rights of management interference in the right of employees to have a collective bargaining agent. In essence, this act both legitimated and helped regulate labor union activities.
- **Fair Labor Standards Act of 1938**, which established a national minimum wage, forbade "oppressive" child labor, and provided for overtime pay in designated occupations. It declared the goal of assuring "a minimum standard of living necessary for the health, efficiency, and general well-being of workers." Today these standards affect more than 130 million workers, both full-time and part-time, in the private and public sectors.
- **Occupational Safety and Health Act of 1970 (OSHA)**, which requires employers to maintain workplace conditions or adopt practices reasonably necessary to protect workers on the job; to be familiar with and comply with standards applicable to their establishments; and ensure that employees have and use personal protective equipment when required for safety and health. The major areas covered by OSHA standards are toxic substances, harmful physical agents, electrical hazards, fall hazards, hazards associated with trenches and digging, hazardous waste, infectious disease, fire and explosion dangers, dangerous atmospheres, machine hazards, and confined spaces.
- **Immigration Reform and Control Act of 1986**, which requires employers to verify the identity and employment authorization of all new hires, whether they are citizens or noncitizens. Employers must do this by ensuring proper completion of Form I-9 for each individual they hire for employment in the United States.
- **Family and Medical Leave Act of 1993**, which requires businesses with fifty or more employees to provide up to twelve weeks of unpaid leave per year upon the birth or adoption of an employee's child or in the event of serious illness to a parent, spouse, or child.

The Top Five Manager Mistakes That Cause Lawsuits

There has been an explosion in the number of employee lawsuits in the U.S. during the past few years. According to the EEOC, employee lawsuits have risen 425 percent since 1995, and the trend does not appear to be diminishing. Sadly, many of these lawsuits can be avoided because manager mistakes are at the center of many of them. That's why it's important to know at least the basics of employment law. In the following video, Business Management Daily's editorial director Pat DiDomenico describes the top five manager mistakes that cause lawsuits.



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4. http://247wallst.com/special-report/2016/06/10/the-worst-companies-to-work-for-2/6/ ↵
5. http://247wallst.com/special-report/2016/06/10/the-worst-companies-to-work-for-2/6/ ↵
6. https://www.eeoc.gov/eeoc/newsroom/release/2-4-15.cfm ↵

8.2: Human Resource Management

What you'll learn to do: explain how the functions of human resource management contribute to business success

In this section you'll discover that human resource management involves a lot more than just hiring and firing employees. It's an integral part of any business's success and it requires a surprisingly diverse skill set to do it well.

Learning Objectives

- Explain how the functions of human resource management contribute to business success

Human Resource Management

What do all businesses have in common regardless of the product or service? Employees! Unless you are a sole proprietorship, you will have to navigate the process of planning for, recruiting, hiring, training, managing, and possibly firing employees. These responsibilities all fall under the heading of human resource management. **Human resource management** (**HRM** or **HR**) is essentially the management of human resources. It is a function in organizations designed to maximize employee performance in service of an employer's strategic objectives. HR is primarily concerned with the management of people within organizations, focusing on policies and on systems. HR departments in organizations typically undertake a number of activities, including employee benefits design, employee recruitment, training and development, performance appraisal, and rewarding (e.g., managing pay and benefit systems). HR also concerns itself with organizational change and industrial relations, that is, the balancing of organizational practices with requirements arising from collective bargaining and from governmental laws.

HR is a product of the human relations movement of the early twentieth century, when researchers began documenting ways of creating business value through the strategic management of the workforce. The function was initially dominated by transactional work, such as payroll and benefits administration, but due to globalization, company consolidation, technological advances, and further research, HR today includes strategic initiatives like talent management, industrial and labor relations, and diversity and inclusion.

Most companies focus on lowering employee turnover and on retaining the talent and knowledge held by their workforce. New hiring not only entails a high cost but also increases the risk of a newcomer not being able to replace the person who worked in a position before. HR departments strive to offer benefits that will appeal to workers, thus reducing the risk of losing corporate knowledge. Businesses are moving globally and forming more diverse teams. It is the role of human resources to make sure that these teams can function and people are able to communicate cross-culturally and across borders. Due to changes in business, current topics in human resources are diversity and inclusion as well as using technology to advance employee engagement.

In short, HR involves maximizing employee productivity. HR managers may also focus on a particular aspect of HRM, such as recruiting, training, employee relations, or benefits. Recruiting specialists are in charge of finding and hiring top talent. Training and development professionals ensure that employees are trained and receive ongoing professional development. This takes place through training programs, performance evaluations, and reward programs. Employee relations deals with employee concerns and incidents such as policy violations, sexual harassment, and discrimination. Benefit managers develop compensation structures, family-leave programs, discounts, and other benefits available to employees. At the other end of the spectrum are HR generalists who work in all areas or as labor relations representatives for unionized employees.

Core Functions of HR

Human resources (HR) professionals conduct a wide variety of tasks within an organizational structure. A brief rundown on the core functions of human resource departments will be useful in framing the more common activities a human resource professional will conduct. The core functions can be summarized as follows:

Staffing

This includes the activities of hiring new full-time or part-time employees, hiring contractors, and terminating employee contracts.

Staffing activities include:

- Identifying and fulfilling talent needs (through recruitment, primarily)

- Utilizing various recruitment technologies to acquire a high volume and diverse pool of candidates (and to filter them based on experience)
- Protecting the company from lawsuits by satisfying legal requirements and maintaining ethical hiring practices
- Writing employee contracts and negotiating salary and benefits
- Terminating employee contracts when necessary

Training and Professional Development

On-boarding new employees and providing professional development opportunities is a key investment for organizations, and HR is charged with seeing that those efforts and resources are well spent and utilized.

Development activities include:

- Training and preparing new employees for their roles
- Providing training opportunities (internal training, educational programs, conferences, etc.) to keep employees up to date in their respective fields
- Preparing management prospects and providing feedback to employees and managers

Compensation

Salary and benefits are also within the scope of human resource management. This includes identifying appropriate compensation based on role, performance, and legal requirements.

Compensation activities include:

- Setting compensation levels to be competitive and appropriate within the market, using benchmarks such as industry standards for a given job function
- Negotiating group health insurance rates, retirement plans, and other benefits with third-party providers
- Discussing raises and other compensation increases and/or decreases with employees in the organization
- Ensuring compliance with legal and cultural expectations when it comes to employee compensation

Safety and Health

HR managers are also responsible for understanding and implementing the best safety and health practices in their industry and addressing any relevant employee concerns.

Safety and health activities include the following:

- Ensuring compliance with legal requirements based on job function for safety measures (i.e., hard hats in construction, available counseling for law enforcement, appropriate safety equipment for chemists, etc.). Many of these requirements are specified by the Occupational Safety and Health Administration (OSHA).
- Implementing new safety measures when laws change in a given industry
- Discussing safety and compliance with relevant government departments
- Discussing safety and compliance with unions

Employee and Labor Relations

Defending employee rights, coordinating with unions, and mediating disagreements between the organization and its human resources are also core HR functions.

Employee and labor relations activities include:

- Mediating disagreements between employees and employers
- Mediating disagreements between employees and other employees
- Investigating claims of harassment and other workplace abuses
- Discussing employee rights with unions, management, and stakeholders
- Acting as the voice of the organization and/or the voice of the employees during any broader organizational issues pertaining to employee welfare

In this module you will explore each of these core functions in greater depth and also learn about the main challenges facing today's HR professional.

8.3: Recruitment and Hiring

What you'll learn to do: discuss how organizations can effectively recruit and hire employees

In this section you'll learn how organizations approach the tasks of recruiting and hiring the best employees.

Learning Objectives

- Describe common recruitment strategies
- Describe the components of the hiring process

Diversity in Human Resources

What Is Diversity?

The term *diversity* often generates controversy, confusion, and tension. What does it mean? Is it the same as affirmative action?

When people refer to diversity, they may be thinking first of ethnicity and race, and then, of gender; however, diversity is much broader than that. The following definition, from *Workforce America! Managing Employee Diversity As a Vital Resource*, does a good job of capturing the subjective nature of the term: Diversity is "otherness or those human qualities that are different from our own and outside the groups to which we belong, yet present in other individuals and groups." In other words, diversity can apply to anyone you perceive to be different from yourself. Dimensions of diversity include, but are not limited to age, ethnicity, ancestry, gender, physical abilities/qualities, race, sexual orientation, educational background, geographic location, income, marital status, military experience, religious beliefs, parental status, and work experience.[1]

How Businesses Benefit from Diversity

There are many arguments for fostering diversity in business, including the availability of talent, the enhancement of interpersonal innovation, risk avoidance, and appealing to a global customer base. The business case for diversity is driven by the view that diversity brings substantial potential benefits, such as better decision making, improved problem solving, and greater creativity and innovation, which lead to enhanced product development and more successful marketing to different types of customers.

Innovation. It is widely noted that diverse teams lead to more innovative and effective ideas and implementations. The logic behind this is relatively simple. Innovative thinking requires individuals to go outside of the normal paradigms of operation, using diverse perspectives to reach new and creative thinking. A group of similar individuals with similar skills is much less likely to stumble across or generate new ideas that lead to innovation. Similarity can cause groupthink, which diminishes creativity.

Localization. Some theorize that, in a global marketplace, a company that employs a diverse workforce is better able to understand the demographics of the global consumer marketplace it serves, and is therefore better equipped to thrive in that marketplace than a company that has a more limited range of employee demographics. With the emerging markets around the world demonstrating substantial GDP growth, organizations need local talent to enter the marketplace and to communicate effectively. Individuals from a certain region will have a deep awareness of the needs in that region, as well as a similar culture, enabling them to add considerable value.

Adaptability. Finally, organizations must be technologically and culturally adaptable in the modern economy. This is crucial to reacting to competitive dynamics quickly and staying ahead of industry trends. Diversity fosters creative thinking and improved decision making through a deeper and more comprehensive worldview. A company willing to diversify draws from a larger talent pool and hires individuals with diverse skill sets. The value of this, particularly at the managerial level, is enormous.

The Role of Human Resource Management

When it comes to the workplace, the human resource department has a great deal of responsibility in managing the overall diversity of the organization. Human resources should consider diversity within the following areas:

- Hiring
- Promotion
- Compensation equality
- Training
- Employee policies
- Legal regulations

- Ensuring accessibility of important documents (e.g., translating human resource materials into other languages so all staff can read them)

The role of human resources is to ensure that all employee concerns are being met and that employee problems are solved when they arise. Human resource professionals must also pursue corporate strategy and adhere to legal concerns when hiring, firing, paying, and regulating employees. This requires careful and meticulous understanding of both the legal and organizational contexts as they pertain to diversity management.

Challenges to Diversity

There are various challenges to achieving diversity in the workplace, ranging from the difficulties of defining the term to the individual, interpersonal, and organizational challenges involved in implementing diversity practices. Though the advantages of diversity are well established, establishing a more diverse workforce brings with it obstacles, in both the assimilation of new cultures into the majority and wage-equality and upper-level opportunities across the minority spectrum. Some of the most common challenges to building a diverse workforce are the following:

- **Stereotypes.** One challenge of creating diversity is the biases individuals in the organization may have about others similar to or different from them. This is essentially a tendency to stereotype, which significantly narrows the worldview of the individuals within the organization.
- **Culture.** Managers must understand the customs and cultural norms of employees and ensure that they don't violate important cultural rules. It is the role of the managers to change the existing organizational culture to one of diversity and inclusion.
- **Communication.** Whether via language or cultural signals, communication can be especially challenging in the interpersonal arena. Ensuring that all professionals (human resources, management, etc.) have access to resources for localizing or translating issues is a significant challenge in many situations. Poor cross-cultural communication can lead to employee misunderstandings or workplace inefficiencies.

While diversity has clear benefits from an organizational perspective, an additional challenge with diversity comes from mismanagement. Due to the legal framework surrounding diversity in the workplace, there is a potential threat involving the neglect of relevant rules and regulations. Fair, ethical, and nondiscriminatory hiring practices and pay equity for all employees are absolutely essential for managers and human resource professionals to understand and uphold. The legal ramifications of missteps in this particular arena can have high fiscal, branding, and reputation costs.

Recruitment

Recruitment of talented employees is an essential part of any company's ability to achieve success and maintain standards within an organization. Recruiting workers consists of actively compiling a diverse pool of potential candidates who can be considered for employment. A good recruitment policy will do this in a timely, cost-efficient manner. The ultimate goal of any human resources recruitment policy is to develop relationships with potential employees before they may actually be needed while keeping an eye on the costs of doing so. In different industries, the constant need for talent creates a highly competitive marketplace for individuals, and it is important for any manager to be aware of these factors as they develop recruitment programs and policies. As retirement among baby boomers becomes increasing prevalent, victory in the "war for talent" will depend greatly on recruitment policies.

Methods of Recruitment

There are two principal ways to recruit workers: internally and externally. Most companies will actively use both methods, ensuring opportunities for existing employees to move up in the organization while at the same time finding new talent. Depending on the time frame and the specialization of the position to fill, some methods will be more effective than others. In either case, the establishment of a comprehensive job description for every position the company seeks to fill will help to narrow the scope of the search and attract more qualified candidates—which contributes to search efficiency.

Internal recruitment is often the most cost-effective method of recruiting potential employees, as it uses existing company resources and talent pool to fill needs and therefore may not incur any extra costs. This is done in two principal ways:

- **Advertising job openings internally:** This is a method of using existing employees as a talent pool for open positions. It carries the advantage of reallocating individuals who are qualified and familiar with the company's practices and culture while at the same time empowering employees within the organization. It also shows the company's commitment to, and trust in, its current employees taking on new tasks.

- **Using networking:** This method can be used in a variety of different ways. First, this recruitment technique involves simply posting the question to existing employees about whether anyone knows of qualified candidates who could fill a particular position. Known as employee referrals, this method often includes giving bonuses to the existing employee if the recommended applicant is hired. Another method uses industry contacts and membership in professional organizations to help create a talent pool via word-of-mouth information regarding the needs of the organization.

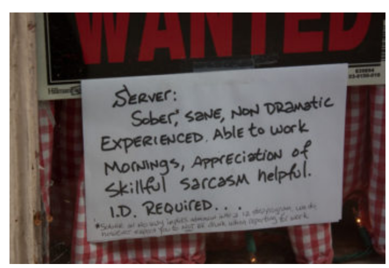
External recruitment focuses on searching outside the organization for potential candidates and expanding the available talent pool. The primary goal of external recruitment is to create diversity and expand the candidate pool. Although external recruitment methods can be costly to managers in terms of dollars, the addition of a new perspective within the organization can bring many benefits that outweigh the costs. External recruitment can be done in a variety of ways:

- **Online recruitment:** The use of the Internet to find a talent pool is quickly becoming the preferred way of recruiting, due to its ability to reach such a wide array of applicants quickly and cheaply. First, the use of the company Web site can enable a business to compile a list of potential applicants who are very interested in the company while at the same time giving them exposure to the company's values and mission. In order to be successful using this recruitment method, a company must ensure that postings and the process for submitting resumes are as transparent and simple as possible. Another popular use of online recruiting is through career Web sites (e.g., Monster.com or Careerbuilder.com). These sites charge employers a set fee for a job posting, which can remain on the Web site for specified period of time. These sites also carry a large database of applicants and allow clients to search their database to find potential employees.
- **Traditional advertising:** This often incorporates one or many forms of advertising, ranging from newspaper classifieds to radio announcements. It is estimated that companies spend USD 2.18 billion annually on these types of ads.[2] Before the emergence of the Internet, this was the most popular form of recruitment for organizations, but the decline of newspaper readership has made it considerably less effective.[3]
- **Job fairs and campus visits:** Job fairs are designed to bring together a comprehensive set of employers in one location so that they may gather and meet with potential employees. The costs of conducting a job fair are distributed across the various participants and can attract an extremely diverse set of applicants. Depending on the proximity to a college or university, campus visits help to find candidates who are looking for the opportunity to prove themselves and have the minimum qualifications, such as a college education, that a firm seeks.
- **Headhunters and recruitment services:** These outside services are designed to compile a talent pool for a company; however they can be extremely expensive. Although these service can be extremely efficient in providing qualified applicants for specialized or highly demanded job positions, the rate for the services provided by headhunters can range from 20 percent to 35 percent of the new recruit's annual salary if the individual is hired.[4]

No matter how a company decides to recruit, the ultimate test is the ability of a recruitment strategy to produce viable applicants. Each manager will face different obstacles in doing this. It is important to remember that recruiting is not simply undertaken at a time of need for an organization but rather is an ongoing process that involves maintaining a talent pool and frequent contact with candidates.

The Hiring Process

Selective Hiring



In recruiting, it is beneficial to attract not only a large number of applicants but a group of individuals with the necessary skills and requirements for the position. After obtaining a substantial, qualified applicant base, managers need to identify those applicants with the highest potential for success at the organization. According to Pfeffer and Veiga, selecting the best person for the job is an extremely critical part of the human resources inflow process.[5] Selective hiring helps prevent the costly turnover of staff and increases the likeliness of high employee morale and productivity.

In order to evaluate the fit, it is important for managers to create a list of relevant criteria for each position before beginning the recruitment and selection process. Each job description should be associated with a list of critical skills, behaviors, or attitudes that will make or break the job performance. When screening potential employees, managers need to select based on cultural fit and attitude as well as on technical skills and competencies. There are some U.S. companies, such as Southwest Airlines, that hire primarily on the basis of attitude because they espouse the philosophy that you *hire for attitude and train for skill*. According to former CEO Herb Kelleher, “We can change skill levels through training. We can’t change attitude.”[6] After determining the most important qualifications, managers can design the rest of the selection process so that it aligns with the other human resource processes.

Screening

Managers strive to identify the best applicants at the lowest cost. Companies have a range of processes for screening potential employees, so managers must determine which system will generate the best results. The methods of screening vary both in levels of effectiveness and in cost of application. In addition to biographical information, companies can conduct background checks or require testing. Because of the costs associated with these measures, companies try to narrow down the number of applicants in the screening process, choosing only the most suitable candidates for interviews. In the United States, the selection process is subject to Equal Employment Opportunity guidelines, which means that companies must be able to show that the process is valid, reliable, related to critical aspects of the the job, and nondiscriminatory. Taking such measures helps companies avoid litigation.

Interviews

As mentioned, it is important to first define the skills and attributes necessary to succeed in the specified position, then develop a list of questions that directly relate to the job requirements. The best interviews follow a structured framework in which each applicant is asked the same questions and is scored with a consistent rating process. Having a common set of information about the applicants to compare after all the interviews have been conducted helps hiring managers avoid prejudice and ensure that all interviewees are given a fair chance.[7] Structured interviews also helps managers avoid illegal questions, such as asking a woman whether she is pregnant. Many companies choose to use several rounds of screening with different interviewers to discover additional facets of the applicant’s attitude or skill as well as develop a more well-rounded opinion of the applicant from diverse perspectives. Involving senior management in the interview process also acts as a signal to applicants about the company culture and value of each new hire. There are two common types of interviews: behavioral and situational.

Behavioral Interviews

In a behavioral interview, the interviewer asks the applicant to reflect on his or her past experiences.[8] After deciding what skills are needed for the position, the interviewer will ask questions to find out if the candidate possesses these skills. The purpose of behavioral interviewing is to find links between the job’s requirement and how the applicant’s experience and past behaviors match those requirements. The following are examples of behavioral interview questions:

> *"Describe a time when you were faced with a stressful situation. How did you handle the situation?*
>
> *Give me an example of when you showed initiative and assumed a leadership role?"*

Situational Interviews

A situational interview requires the applicant to explain how he or she would handle a series of hypothetical situations. Situational-based questions evaluate the applicant’s judgment, ability, and knowledge.[9] Before administering this type of interview, it is a good idea for the hiring manager to consider possible responses and develop a scoring key for evaluation purposes. Examples of situational interview questions:

> *"You and a colleague are working on a project together; however, your colleague fails to do his agreed portion of the work. What would you do?*
>
> *A client approaches you and claims that she has not received a payment that supposedly had been sent five days ago from your office. She is very angry. What would you do?"*

Selection Tests

For some companies, understanding the applicant’s personality, values, and motivation for wanting the job is a critical part of the hiring decision. For some positions, although technical aptitude is required, the candidate’s attitude is often just as important. Under these circumstances, companies may use behavioral assessments and personality profiles. The goal of these assessments is to predict how the individual will interact with their coworkers, customers, and supervisors. Tests such as the IPIP (International Personality Item Pool) and Wonderlic are popular tools that provide an analysis of an applicant’s personality, attitudes, and interpersonal skills; however, it is *critical* that the tests be administered, scored, and interpreted by a licensed professional. Other selection tests used in hiring may include cognitive tests, which measure general intelligence, work sample tests, which demonstrate the applicant's ability to perform specific job duties, and integrity tests, which measure honesty.

Background Checks

Background checks are a way for employers to verify the accuracy of information provided by applicants in résumés and applications. Information gathered in background checks may include employment history, education, credit reports, driving records, and criminal records. Employers must obtain written consent from the applicant before conducting a background check, and the information gathered in a background check should be relevant to the job.

Evaluation

Employers may choose to use just one or a combination of the screening methods to predict future job performance. It is important for companies to use metrics to assess the effectiveness of their selective hiring process. This provides a benchmark for future performance as well as a means of evaluating the success of a particular method. Companies can continuously improve their selection practices to ensure that they hire people who will successfully meet job requirements as well as fit into the organizational culture. If companies are not successful in their hiring practices, high turnover, low employee morale, and decreased productivity will result. Research shows that the "degree of cultural fit and value congruence between job applicants and their organizations significantly predicts both subsequent turnover and job performance."[10] Thus, companies need to assess their hiring in terms of technical success as well as cultural fit. Evaluating the hiring process will help ensure continuing success, because human capital is often a company's most important asset.

How do hiring decisions affect a company's success? Zappos is well known for consistently providing excellent customer service. In the video below, CEO Tony Hsieh explains how company values drive their hiring decisions.

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3. Heathfield, Use the Web for Recruiting: Recruiting Online ↵
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CHAPTER OVERVIEW

9: Management

9.1: Principles of Management
9.2: Organizational Culture
9.3: Employee Motivation

9.1: Principles of Management

Learning Objectives

1. Know the dimensions of the planning-organizing-leading-controlling (P-O-L-C) framework.
2. Know the general inputs into each P-O-L-C dimension.

A manager's primary challenge is to solve problems creatively. While drawing from a variety of academic disciplines, and to help managers respond to the challenge of creative problem solving, principles of management have long been categorized into the four major functions of planning, organizing, leading, and controlling (the P-O-L-C framework). The four functions, summarized in the P-O-L-C figure, are actually highly integrated when carried out in the day-to-day realities of running an organization. Therefore, you should not get caught up in trying to analyze and understand a complete, clear rationale for categorizing skills and practices that compose the whole of the P-O-L-C framework.

It is important to note that this framework is not without criticism. Specifically, these criticisms stem from the observation that the P-O-L-C functions might be ideal but that they do not accurately depict the day-to-day actions of actual managers (Mintzberg, 1973; Lamond, 2004). The typical day in the life of a manager at any level can be fragmented and hectic, with the constant threat of having priorities dictated by the law of the trivial many and important few (i.e., the 80/20 rule). However, the general conclusion seems to be that the P-O-L-C functions of management still provide a very useful way of classifying the activities managers engage in as they attempt to achieve organizational goals (Lamond, 2004).

Planning	Organizing	Leading	Controlling
1. Vision & Mission 2. Strategizing 3. Goals & Objectives	1. Organization Design 2. Culture 3. Social Networks	1. Leadership 2. Decision Making 3. Communications 4. Groups/Teams 5. Motivation	1. Systems/Processes 2. Strategic Human Resources

Planning

Planning is the function of management that involves setting objectives and determining a course of action for achieving those objectives. Planning requires that managers be aware of environmental conditions facing their organization and forecast future conditions. It also requires that managers be good decision makers.

Planning is a process consisting of several steps. The process begins with **environmental scanning** which simply means that planners must be aware of the critical contingencies facing their organization in terms of economic conditions, their competitors, and their customers. Planners must then attempt to forecast future conditions. These forecasts form the basis for planning.

Planners must establish objectives, which are statements of what needs to be achieved and when. Planners must then identify alternative courses of action for achieving objectives. After evaluating the various alternatives, planners must make decisions about the best courses of action for achieving objectives. They must then formulate necessary steps and ensure effective implementation of plans. Finally, planners must constantly evaluate the success of their plans and take corrective action when necessary.

There are many different types of plans and planning.

Strategic planning involves analyzing competitive opportunities and threats, as well as the strengths and weaknesses of the organization, and then determining how to position the organization to compete effectively in their environment. Strategic planning has a long time frame, often three years or more. Strategic planning generally includes the entire organization and includes formulation of objectives. Strategic planning is often based on the organization's mission, which is its fundamental reason for existence. An organization's top management most often conducts strategic planning.

Tactical planning is intermediate-range (one to three years) planning that is designed to develop relatively concrete and specific means to implement the strategic plan. Middle-level managers often engage in tactical planning.

Operational planning generally assumes the existence of organization-wide or subunit goals and objectives and specifies ways to achieve them. Operational planning is short-range (less than a year) planning that is designed to develop specific action steps that support the strategic and tactical plans.

Organizing

Organizing is the function of management that involves developing an organizational structure and allocating human resources to ensure the accomplishment of objectives. The structure of the organization is the framework within which effort is coordinated. The structure is usually represented by an organization chart, which provides a graphic representation of the chain of command within an organization. Decisions made about the structure of an organization are generally referred to as **organizational design** decisions.

Organizing also involves the design of individual jobs within the organization. Decisions must be made about the duties and responsibilities of individual jobs, as well as the manner in which the duties should be carried out. Decisions made about the nature of jobs within the organization are generally called "job design" decisions.

Organizing at the level of the organization involves deciding how best to departmentalize, or cluster, jobs into departments to coordinate effort effectively. There are many different ways to departmentalize, including organizing by function, product, geography, or customer. Many larger organizations use multiple methods of departmentalization.

Organizing at the level of a particular job involves how best to design individual jobs to most effectively use human resources. Traditionally, **job design** was based on principles of division of labor and specialization, which assumed that the more narrow the job content, the more proficient the individual performing the job could become. However, experience has shown that it is possible for jobs to become too narrow and specialized. For example, how would you like to screw lids on jars one day after another, as you might have done many decades ago if you worked in company that made and sold jellies and jams? When this happens, negative outcomes result, including decreased job satisfaction and organizational commitment, increased absenteeism, and turnover.

Recently, many organizations have attempted to strike a balance between the need for worker specialization and the need for workers to have jobs that entail variety and autonomy. Many jobs are now designed based on such principles as empowerment, **job enrichment** and **teamwork**. For example, HUI Manufacturing, a custom sheet metal fabricator, has done away with traditional "departments" to focus on listening and responding to customer needs. From company-wide meetings to team huddles, HUI employees know and understand their customers and how HUI might service them best (Huimfg, 2008).

Leading

Leading involves the social and informal sources of influence that you use to inspire action taken by others. If managers are effective leaders, their subordinates will be enthusiastic about exerting effort to attain organizational objectives.

The behavioral sciences have made many contributions to understanding this function of management. Personality research and studies of job attitudes provide important information as to how managers can most effectively lead subordinates. For example, this research tells us that to become effective at leading, managers must first understand their subordinates' personalities, values, attitudes, and emotions.

Studies of motivation and motivation theory provide important information about the ways in which workers can be energized to put forth productive effort. Studies of communication provide direction as to how managers can effectively and persuasively communicate. Studies of leadership and leadership style provide information regarding questions, such as, "What makes a manager a good leader?" and "In what situations are certain leadership styles most appropriate and effective?"

Figure 9.1.2:Quality control ensures that the organization delivers on its promises. International Maize and Wheat Improvement Center – Maize seed quality control at small seed company Bidasem – CC BY-NC-SA 2.0.

Controlling

Controlling involves ensuring that performance does not deviate from standards. Controlling consists of three steps, which include (1) establishing performance standards, (2) comparing actual performance against standards, and (3) taking corrective action when necessary. Performance standards are often stated in monetary terms such as revenue, costs, or profits but may also be stated in other terms, such as units produced, number of defective products, or levels of quality or customer service.

The measurement of performance can be done in several ways, depending on the performance standards, including financial statements, sales reports, production results, customer satisfaction, and formal performance appraisals. Managers at all levels engage in the managerial function of controlling to some degree.

The managerial function of controlling should not be confused with control in the behavioral or manipulative sense. This function does not imply that managers should attempt to control or to manipulate the personalities, values, attitudes, or emotions of their subordinates. Instead, this function of management concerns the manager's role in taking necessary actions to ensure that the work-related activities of subordinates are consistent with and contributing toward the accomplishment of organizational and departmental objectives.

Effective controlling requires the existence of plans, since planning provides the necessary performance standards or objectives. Controlling also requires a clear understanding of where responsibility for deviations from standards lies. Two traditional control techniques are budget and performance audits. An audit involves an examination and verification of records and supporting documents. A budget audit provides information about where the organization is with respect to what was planned or budgeted for, whereas a performance audit might try to determine whether the figures reported are a reflection of actual performance. Although controlling is often thought of in terms of financial criteria, managers must also control production and operations processes, procedures for delivery of services, compliance with company policies, and many other activities within the organization.

The management functions of planning, organizing, leading, and controlling are widely considered to be the best means of describing the manager's job, as well as the best way to classify accumulated knowledge about the study of management. Although there have been tremendous changes in the environment faced by managers and the tools used by managers to perform their roles, managers still perform these essential functions.

Key Takeaway

The principles of management can be distilled down to four critical functions. These functions are planning, organizing, leading, and controlling. This P-O-L-C framework provides useful guidance into what the ideal job of a manager should look like.

Exercises

1. What are the management functions that comprise the P-O-L-C framework?
2. Are there any criticisms of this framework?
3. What function does planning serve?
4. What function does organizing serve?
5. What function does leading serve?
6. What function does controlling serve?

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Figure 9.1.1: The P-O-L-C Framework

9.2: Organizational Culture

Learning Objectives

1. Define organizational culture.
2. Understand why organizational culture is important.
3. Understand the different levels of organizational culture.

What Is Organizational Culture?

Organizational culture refers to a system of shared assumptions, values, and beliefs that show people what is appropriate and inappropriate behavior (Chatman & Eunyoung, 2003; Kerr & Slocum, 2005). These values have a strong influence on employee behavior as well as organizational performance. In fact, the term organizational culture was made popular in the 1980s when Peters and Waterman's best-selling book *In Search of Excellence* made the argument that company success could be attributed to an organizational culture that was decisive, customer-oriented, empowering, and people-oriented. Since then, organizational culture has become the subject of numerous research studies, books, and articles. Organizational culture is still a relatively new concept. In contrast to a topic such as leadership, which has a history spanning several centuries, organizational culture is a young but fast-growing area within management.

Culture is largely invisible to individuals just as the sea is invisible to the fish swimming in it. Even though it affects all employee behaviors, thinking, and behavioral patterns, individuals tend to become more aware of their organization's culture when they have the opportunity to compare it to other organizations. It is related to the second of the three facets that compose the P-O-L-C function of organizing. The organizing function involves creating and implementing organizational design decisions. The culture of the organization is closely linked to organizational design. For instance, a culture that empowers employees to make decisions could prove extremely resistant to a centralized organizational design, hampering the manager's ability to enact such a design. However, a culture that supports the organizational structure (and vice versa) can be very powerful.

Why Does Organizational Culture Matter?

An organization's culture may be one of its strongest assets or its biggest liability. In fact, it has been argued that organizations that have a rare and hard-to-imitate culture enjoy a competitive advantage (Barney, 1986). In a survey conducted by the management consulting firm Bain & Company in 2007, worldwide business leaders identified corporate culture to be as important as corporate strategy for business success. [1] This comes as no surprise to leaders of successful businesses, who are quick to attribute their company's success to their organization's culture.

Culture, or shared values within the organization, may be related to increased performance. Researchers found a relationship between organizational cultures and company performance, with respect to success indicators such as revenues, sales volume, market share, and stock prices (Kotter & Heskett, 1992; Marcoulides & heck, 1993). At the same time, it is important to have a culture that fits with the demands of the company's environment. To the extent that shared values are proper for the company in question, company performance may benefit from culture (Arogyaswamy & Byles, 1987). For example, if a company is in the high-tech industry, having a culture that encourages innovativeness and adaptability will support its performance. However, if a company in the same industry has a culture characterized by stability, a high respect for tradition, and a strong preference for upholding rules and procedures, the company may suffer because of its culture. In other words, just as having the "right" culture may be a competitive advantage for an organization, having the "wrong" culture may lead to performance difficulties, may be responsible for organizational failure, and may act as a barrier preventing the company from changing and taking risks.

In addition to having implications for organizational performance, *organizational culture is an effective control mechanism dictating employee behavior*. Culture is a more powerful way of controlling and managing employee behaviors than organizational rules and regulations. For example, when a company is trying to improve the quality of its customer service, rules may not be helpful, particularly when the problems customers present are unique. Instead, creating a culture of customer service may achieve better results by encouraging employees to think like customers, knowing that the company priorities in this case are clear: Keeping the customer happy is preferable to other concerns, such as saving the cost of a refund. Therefore, the ability to understand and influence organizational culture is an important item for managers to have in their tool kit when they are carrying out their controlling P-O-L-C function as well as their organizing function.

Levels of Organizational Culture

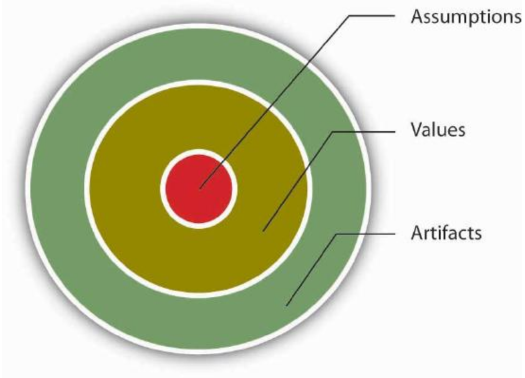

Figure 8.5 Three Levels of Organizational Culture Adapted from Schein, E. H. (1992). *Organizational Culture and Leadership*. San Francisco: Jossey-Bass.

Organizational culture consists of some aspects that are relatively more visible, as well as aspects that may lie below one's conscious awareness. Organizational culture can be thought of as consisting of three interrelated levels (Schein, 1992).

At the deepest level, below our awareness, lie basic assumptions. These assumptions are taken for granted and reflect beliefs about human nature and reality. At the second level, values exist. Values are shared principles, standards, and goals. Finally, at the surface, we have artifacts, or visible, tangible aspects of organizational culture. For example, in an organization, a basic assumption employees and managers share might be that happy employees benefit their organizations. This might be translated into values such as egalitarianism, high-quality relationships, and having fun. The artifacts reflecting such values might be an executive "open door" policy, an office layout that includes open spaces and gathering areas equipped with pool tables, and frequent company picnics.

Understanding the organization's culture may start from observing its artifacts: its physical environment, employee interactions, company policies, reward systems, and other observable characteristics. When you are interviewing for a position, observing the physical environment, how people dress, where they relax, and how they talk to others is definitely a good start to understanding the company's culture. However, simply looking at these tangible aspects is unlikely to give a full picture of the organization, since an important chunk of what makes up culture exists below one's degree of awareness. The values and, deeper, the assumptions that shape the organization's culture can be uncovered by observing how employees interact and the choices they make, as well as by inquiring about their beliefs and perceptions regarding what is right and appropriate behavior.

Key Takeaway

Organizational culture is a system of shared assumptions, values, and beliefs that helps individuals understand which behaviors are and are not appropriate within an organization. Cultures can be a source of competitive advantage for organizations. Strong organizational cultures can be an organizing as well as a controlling mechanism for organizations. And finally, organizational culture consists of three levels: assumptions that are below the surface, values, and artifacts.

Exercises

1. Why do companies need culture?
2. Give an example of a company culture being a strength and a weakness.
3. In what ways does culture serve as a controlling mechanism?
4. If assumptions are below the surface, why do they matter?
5. Share examples of artifacts you have noticed at different organizations.

[1]Why culture can mean life or death for your organization. (September, 2007). *HR Focus, 84*, 9.

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9.3: Employee Motivation

Learning Objectives

1. Explain how employees are motivated according to Maslow's hierarchy of needs.
2. Explain how ERG theory addresses the limitations of Maslow's hierarchy.
3. Describe the difference between factors contributing to employee motivation and how these differ from factors contributing to dissatisfaction.
4. Describe the needs for achievement, power, and affiliation, and how these needs affect work behavior.

The earliest answer to motivation involved understanding individual needs. Specifically, early researchers thought that employees try hard and demonstrate goal-driven behavior to satisfy needs. For example, an employee who is always walking around the office talking to people may have a need for companionship and his behavior may be a way of satisfying this need. There are four major theories in the need-based category: Maslow's hierarchy of needs, ERG theory, Herzberg's dual factor theory, and McClelland's acquired needs theory.

Maslow's Hierarchy of Needs

Abraham Maslow is among the most prominent psychologists of the 20th century and the hierarchy of needs, accompanied by the pyramid representing how human needs are ranked, is an image familiar to most business students and managers. Maslow's theory is based on a simple premise: Human beings have needs that are hierarchically ranked (Maslow, 1943; Maslow, 1954). There are some needs that are basic to all human beings, and in their absence, nothing else matters. As we satisfy these basic needs, we start looking to satisfy higher-order needs. Once a lower-level need is satisfied, it no longer serves as a motivator.

The most basic of Maslow's needs are physiological needs. Physiological needs refer to the need for air, food, and water. Imagine being very hungry. At that point, all your behavior may be directed at finding food. Once you eat, though, the search for food ceases and the promise of food no longer serves as a motivator. Once physiological needs are satisfied, people tend to become concerned about safety. Are they safe from danger, pain, or an uncertain future? One level up, social needs refer to the need to bond with other human beings, to be loved, and to form lasting attachments. In fact, having no attachments can negatively affect health and well-being (Baumeister & Leary, 1995). The satisfaction of social needs makes esteem needs more salient. Esteem needs refer to the desire to be respected by one's peers, feeling important, and being appreciated. Finally, at the highest level of the hierarchy, the need for self-actualization refers to "becoming all you are capable of becoming." This need manifests itself by acquiring new skills, taking on new challenges, and behaving in a way that will lead to the satisfaction of one's life goals.

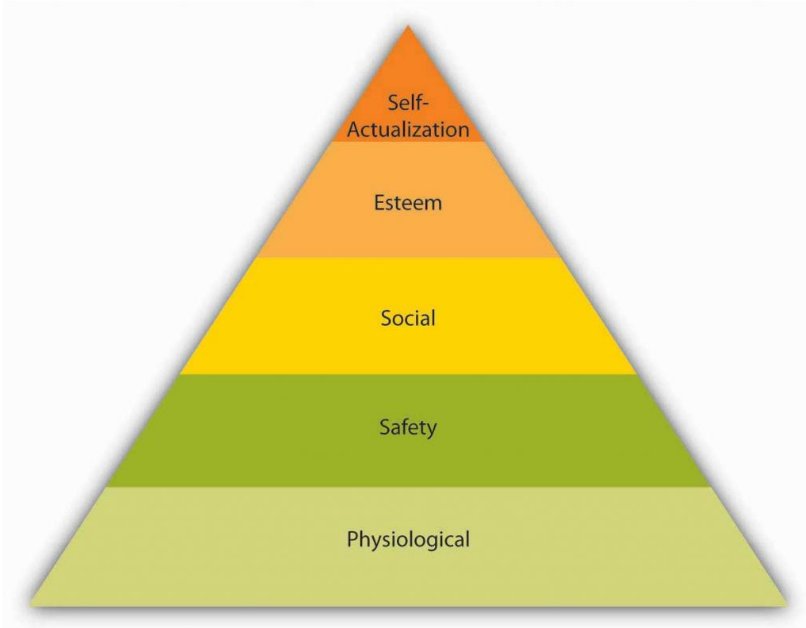

Figure 9.3.1: Maslow's Hierarchy of Needs *Source*: Adapted from Maslow, A. H. (1954). *Motivation and personality*. New York: Harper.

Maslow's hierarchy is a systematic way of thinking about the different needs employees may have at any given point and explains different reactions they may have to similar treatment. An employee who is trying to satisfy her esteem needs may feel gratified when her supervisor praises her. However, another employee who is trying to satisfy his social needs may resent being praised by upper management in front of peers if the praise sets him apart from the rest of the group.

So, how can organizations satisfy their employees' various needs? By leveraging the various facets of the planning-organizing-leading-controlling (P-O-L-C) functions. In the long run, physiological needs may be satisfied by the person's paycheck, but it is important to remember that pay may satisfy other needs such as safety and esteem as well. Providing generous benefits, including health insurance and company-sponsored retirement plans, as well as offering a measure of job security, will help satisfy safety needs. Social needs may be satisfied by having a friendly environment, providing a workplace conducive to collaboration and communication with others. Company picnics and other social get-togethers may also be helpful if the majority of employees are motivated primarily by social needs (but may cause resentment if they are not and if they have to sacrifice a Sunday afternoon for a company picnic). Providing promotion opportunities at work, recognizing a person's accomplishments verbally or through more formal reward systems, job titles that communicate to the employee that one has achieved high status within the organization are among the ways of satisfying esteem needs. Finally, self-actualization needs may be satisfied by providing development and growth opportunities on or off the job, as well as by assigning interesting and challenging work. By making the effort to satisfy the different needs each employee may have at a given time, organizations may ensure a more highly motivated workforce.

ERG Theory

ERG theory of Clayton Alderfer is a modification of Maslow's hierarchy of needs (Alderfer, 1969). Instead of the five needs that are hierarchically organized, Alderfer proposed that basic human needs may be grouped under three categories, namely, Existence, Relatedness, and Growth (see the following figure). Existence need corresponds to Maslow's physiological and safety needs, relatedness corresponds to social needs, and growth need refers to Maslow's esteem and self actualization.

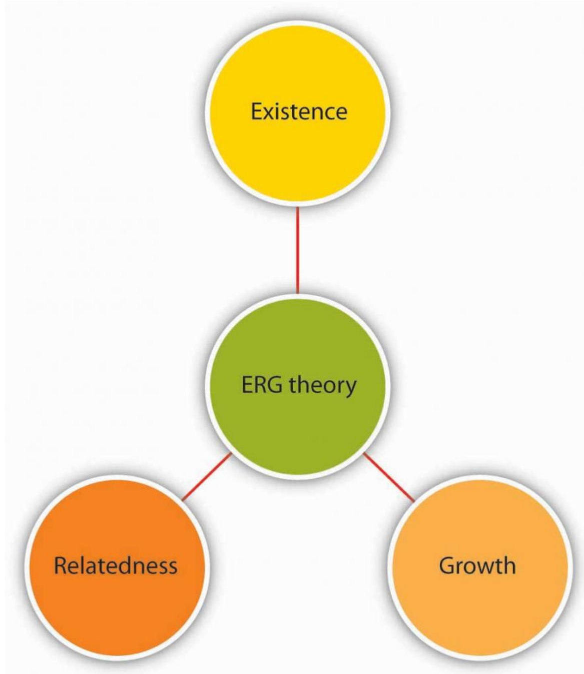

Figure 9.3.2: ERG Theory *Source*: Based on Alderfer, C. P. (1969). An empirical test of a new theory of human needs. *Organizational Behavior and Human Performance, 4*, 142–175.

Source: Based on Alderfer, C. P. (1969). An empirical test of a new theory of human needs. *Organizational Behavior and Human Performance, 4*, 142–175.

ERG theory's main contribution to the literature is its relaxation of Maslow's assumptions. For example, ERG theory does not rank needs in any particular order and explicitly recognizes that more than one need may operate at a given time. Moreover, the theory has a "frustration-regression" hypothesis, suggesting that individuals who are frustrated in their attempts to satisfy one need may regress to another one. For example, someone who is frustrated by the lack of growth opportunities in his job and slow progress toward career goals may regress to relatedness needs and start spending more time socializing with one's coworkers. The implication of this theory is that we need to recognize the multiple needs that may be driving an individual at a given point to understand his behavior and to motivate him.

Two-Factor Theory

Frederick Herzberg approached the question of motivation in a different way. By asking individuals what satisfies them on the job and what dissatisfies them, Herzberg came to the conclusion that aspects of the work environment that satisfy employees are very different from aspects that dissatisfy them (Herzberg, et. al., 1959; Herzberg, 1965). Herzberg labeled factors causing dissatisfaction of workers as "hygiene" factors because these factors were part of the context in which the job was performed, as opposed to the job itself. Hygiene factors included company policies, supervision, working conditions, salary, safety, and security on the job. To illustrate, imagine that you are working in an unpleasant work environment. Your office is too hot in the summer and too cold in the winter. You are being harassed and mistreated. You would certainly be miserable in such a work environment. However, if these problems were solved (your office temperature is just right and you are not harassed at all), would you be motivated? Most likely, you would take the situation for granted. In fact, many factors in our work environment are things that we miss when they are absent, but take for granted if they are present.

In contrast, motivators are factors that are intrinsic to the job, such as achievement, recognition, interesting work, increased responsibilities, advancement, and growth opportunities. According to Herzberg's research, motivators are the conditions that truly encourage employees to try harder.

Figure 9.3.3: Two-Factor Theory of Motivation *Source*: Based on Herzberg, F., Mausner, B., & Snyderman, B. (1959). *The motivation to work*. New York: Wiley; Herzberg, F. (1965). The motivation to work among Finnish supervisors. *Personnel Psychology*, *18*, 393–402.

Herzberg's research, which is summarized in the figure above, has received its share of criticism (Cummings & Elsalmi, 1968; House & Wigdor, 1967). One criticism relates to the classification of the factors as hygiene or motivator. For example, pay is viewed as a hygiene factor. However, pay is not necessarily a contextual factor and may have symbolic value by showing employees that they are being recognized for their contributions as well as communicating to them that they are advancing within the company. Similarly, quality of supervision or relationships employees form with their supervisors may determine whether they are assigned interesting work, whether they are recognized for their potential, and whether they take on more responsibilities. Despite its limitations, the two-factor theory can be a valuable aid to managers because it points out that improving the environment in which the job is performed goes only so far in motivating employees.

Figure 9.3.4: Plaques and other recognition awards may motivate employees if these awards fit with the company culture and if they reflect a sincere appreciation of employee accomplishments. phjakroon – Pixabay – CC0 public domain.

Acquired Needs Theory

Among the need-based approaches to motivation, Douglas McClelland's acquired needs theory is the one that has received the greatest amount of support. According to this theory, individuals acquire three types of needs as a result of their life experiences. These needs are need for achievement, need for affiliation, and need for power. All individuals possess a combination of these needs.

Those who have high need for achievement have a strong need to be successful. A worker who derives great satisfaction from meeting deadlines, coming up with brilliant ideas, and planning his or her next career move may be high in need for achievement. Individuals high on need for achievement are well suited to positions such as sales where there are explicit goals, feedback is immediately available, and their effort often leads to success (Harrell & Stahl, 1981; Trevis & Certo, 2005; Turban & Keon, 1993). Because of their success in lower-level jobs, those in high need for achievement are often promoted to higher-level positions (McClelland & Boyatzis, 1982). However, a high need for achievement has important disadvantages in management. Management involves getting work done by motivating others. When a salesperson is promoted to be a sales manager, the job description changes from actively selling to recruiting, motivating, and training salespeople. Those who are high in need for achievement may view managerial activities such as coaching, communicating, and meeting with subordinates as a waste of time. Moreover, they enjoy doing things themselves and may find it difficult to delegate authority. They may become overbearing or micromanaging bosses, expecting everyone to be as dedicated to work as they are, and expecting subordinates to do things exactly the way they are used to doing (McClelland & Burnham, 1976).

Individuals who have a high need for affiliation want to be liked and accepted by others. When given a choice, they prefer to interact with others and be with friends (Wong & Csikszentmihalyi, 1991). Their emphasis on harmonious interpersonal relationships may be an advantage in jobs and occupations requiring frequent interpersonal interaction, such as social worker or teacher. In managerial positions, a high need for affiliation may again serve as a disadvantage because these individuals tend to be overly concerned about how they are perceived by others. Thus, they may find it difficult to perform some aspects of a manager's job such as giving employees critical feedback or disciplining poor performers.

Finally, those with high need for power want to influence others and control their environment. Need for power may be destructive of one's relationships if it takes the form of seeking and using power for one's own good and prestige. However, when it manifests itself in more altruistic forms, such as changing the way things are done so that the work environment is more positive or negotiating more resources for one's department, it tends to lead to positive outcomes. In fact, need for power is viewed as important for effectiveness in managerial and leadership positions (Mcclelland & Burnham, 1976; Spangler & House, 1991; Spreier, 2006).

McClelland's theory of acquired needs has important implications for motivating employees. While someone who has high need for achievement may respond to goals, those with high need for affiliation may be motivated to gain the approval of their peers and supervisors, whereas those who have high need for power may value gaining influence over the supervisor or acquiring a position that has decision-making authority. And, when it comes to succeeding in managerial positions, individuals who are aware of the drawbacks of their need orientation can take steps to overcome these drawbacks.

Key Takeaway

Need-based theories describe motivated behavior as individual efforts to meet needs. According to this perspective, the manager's job is to identify what people need and then to make sure that the work environment becomes a means of satisfying these needs. Maslow's hierarchy categorizes human needs into physiological, safety, social, esteem, and self-actualization needs. ERG theory is a modification of Maslow's hierarchy, where the five needs are collapsed into three categories (existence, relatedness, and growth). The two-factor theory differentiates between factors that make people dissatisfied on the job (hygiene factors) and factors that truly motivate employees. Finally, acquired-needs theory argues that individuals possess stable and dominant motives to achieve, acquire power, or affiliate with others. Each of these theories explains characteristics of a work environment that motivate employees.

Exercises

1. Many managers assume that if an employee is not performing well, the reason must be lack of motivation. What is the problem with this assumption?
2. Review Maslow's hierarchy of needs. Do you agree with the particular ranking of employee needs?
3. Review the hygiene and motivators in the two-factor theory. Are there any hygiene factors that you would consider to be motivators and vice versa?
4. A friend of yours is competitive, requires frequent and immediate feedback, and enjoys accomplishing things. She has recently been promoted to a managerial position and seeks your advice. What would you tell her?
5. Which motivation theory have you found to be most useful in explaining why people behave in a certain way? Why?

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CHAPTER OVERVIEW

10: Electronic Commerce

10.1: Electronic Commerce Technology

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Introduction

In the first chapter, we argued that organizations need to make a metamorphosis. They have to abandon existing business practices to create new ways of interacting with stakeholders. This chapter will provide you with the wherewithal to understand the technology that enables an organization to make this transformation.

Internet technology

Computers can communicate with each other when they speak a common language or use a common communication protocol. Transmission Control Protocol/Internet Protocol (TCP/IP) is the communication network protocol used on the Internet. TCP/IP has two parts. TCP handles the transport of data, and IP performs routing and addressing.

Data transport

The two main methods for transporting data across a network are circuit and packet switching. Circuit switching is commonly used for voice and package switching for data. Parts of the telephone system still operate as a circuit-switched network. Each link of a predetermined bandwidth is dedicated to a predetermined number of users for a period of time.

The Internet is a packet switching network. The TCP part of TCP/IP is responsible for splitting a message from the sending computer into packets, uniquely numbering each packet, transmitting the packets, and putting them together in the correct sequence at the receiving computer. The major advantage of packet switching is that it permits sharing of resources (e.g., a communication link) and makes better use of available bandwidth.

Routing

Routing is the process of determining the path a message will take from the sending to the receiving computer. It is the responsibility of the IP part of TCP/IP for dynamically determining the best route through the network. Because routing is dynamic, packets of the same message may take different paths and not necessarily arrive in the sequence in which they were sent.

Addressability

Messages can be sent from one computer to another only when every server on the Internet is uniquely addressable. The Internet Network Information Center (InterNIC) manages the assignment of unique IP addresses so that TCP/IP networks anywhere in the world can communicate with each other. An IP address is a unique 32-bit number consisting of four groups of decimal numbers in the range 0 to 255 (e.g., 128.192.73.60). IP numbers are difficult to recall. Humans can more easily remember addresses like aussie.mgmt.uga.edu. A Domain Name Server (DNS) converts aussie.mgmt.uga.edu to the IP address 128.192.73.60. The exponential growth of the Internet will eventually result in a shortage of IP addresses, and the development of next-generation IP (IPng) is underway.

Infrastructure

Electronic commerce is built on top of a number of different technologies. These various technologies created a layered, integrated infrastructure that permits the development and deployment of electronic commerce applications (see Exhibit 9). Each layer is founded on the layer below it and cannot function without it.

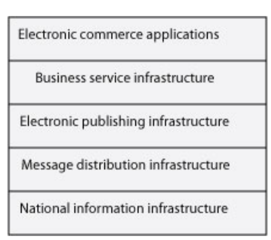

Exhibit 5.: Electronic commerce infrastructure

National information infrastructure

This layer is the bedrock of electronic commerce because all traffic must be transmitted by one or more of the communication networks comprising the national information infrastructure (NII). The components of an NII include the TV and radio broadcast industries, cable TV, telephone networks, cellular communication systems, computer networks, and the Internet. The trend in many countries is to increase competition among the various elements of the NII to increase its overall efficiency because it is believed that an NII is critical to the creation of national wealth.

Message distribution infrastructure

This layer consists of software for sending and receiving messages. Its purpose is to deliver a message from a server to a client. For example, it could move an HTML file from a Web server to a client running Netscape. Messages can be unformatted (e.g., e-mail) or formatted (e.g., a purchase order). Electronic data interchange (EDI), e-mail, and hypertext text transfer protocol (HTTP) are examples of messaging software.

Electronic publishing infrastructure

Concerned with content, the Web is a very good example of this layer. It permits organizations to publish a full range of text and multimedia. There are three key elements of the Web:

- A uniform resource locator (URL), which is used to uniquely identify any server;
- A network protocol;
- A structured markup language, HTML.

Notice that the electronic publishing layer is still concerned with some of the issues solved by TCP/IP for the Internet part of the NII layer. There is still a need to consider addressability (i.e., a URL) and have a common language across the network (i.e., HTTP and HTML). However, these are built upon the previous layer, in the case of a URL, or at a higher level, in the case of HTML.

Business services infrastructure

The principal purpose of this layer is to support common business processes. Nearly every business is concerned with collecting payment for the goods and services it sells. Thus, the business services layer supports secure transmission of credit card numbers by providing encryption and electronic funds transfer. Furthermore, the business services layer should include facilities for encryption and authentication (see See Security).

Electronic commerce applications

Finally, on top of all the other layers sits an application. Consider the case of a book seller with an on-line catalog (see Exhibit 6). The application is a book catalog; encryption is used to protect a customer’s credit card number; the application is written in HTML; HTTP is the messaging protocol; and the Internet physically transports messages between the book seller and customer.

Exhibit 6. An electronic commerce application

Electronic commerce applications	Book catalog
Business services infrastructure	Encryption
Electronic publishing infrastructure	HTML
Message distribution infrastructure	HTTP
National information infrastructure	Internet

Electronic publishing

Two common approaches to electronic publishing are Adobe’s portable document format (PDF) and HTML. The differences between HTML and PDF are summarized in Exhibit 7.

Exhibit 7. HTML versus PDF

HTML	PDF
A markup language	A page description language

HTML files can be created by a wide variety of software. Most word processors can generate HTML	PDF files are created using special software sold by Adobe that is more expensive than many HTML creator alternatives
Browser is free	Viewer is free
Captures structure	Captures structure and layout
Can have links to PDF	Can have links to HTML
Reader can change presentation	Creator determines presentation

PDF

PDF is a page description language that captures electronically the layout of the original document. Adobe's Acrobat Exchange software permits any document created by a DOS, Macintosh, Windows, or Unix application to be converted to PDF. Producing a PDF document is very similar to printing, except the image is sent to a file instead of a printer. The fidelity of the original document is maintained–text, graphics, and tables are faithfully reproduced when the PDF file is printed or viewed. PDF is an operating system independent and printer independent way of presenting the same text and images on many different systems.

PDF has been adopted by a number of organizations, including the Internal Revenue Service for tax forms. PDF documents can be sent as e-mail attachments or accessed from a Web application. To decipher a PDF file, the recipient must use a special reader, supplied at no cost by Adobe for all major operating systems. In the case of the Web, you have to configure your browser to invoke the Adobe Acrobat reader whenever a file with the extension pdf is retrieved.

HTML

HTML is a markup language , which means it marks a portion of text as referring to a particular type of information.6 HTML does not specify how this is to be interpreted; this is the function of the browser. Often the person using the browser can specify how the information will be presented. For instance, using the preference features of your browser, you can indicate the font and size for presenting information. As a result, you can significantly alter the look of the page, which could have been carefully crafted by a graphic artist to convey a particular look and feel. Thus, the you may see an image somewhat different from what the designer intended.

HTML or PDF?

The choice between HTML and PDF depends on the main purpose of the document. If the intention is to inform the reader, then there is generally less concern with how the information is rendered. As long as the information is readable and presented clearly, the reader can be given control of how it is presented. Alternatively, if the goal is to influence the reader (e.g., an advertisement) or maintain the original look of the source document (e.g, a taxation form or newspaper), then PDF is the better alternative. The two formats coexist. A PDF document can include links to a HTML document, and vice versa. Also, a number of leading software companies are working on extensions to HTML that will give the creator greater control of the rendering of HTML (e.g., specifying the font to be used).

Electronic commerce topologies

There are three types of communication networks used for electronic commerce (see Exhibit 8), depending on whether the intent is to support cooperation with a range of stakeholders, cooperation among employees, or cooperation with a business partner. Each of these topologies is briefly described, and we discuss how they can be used to support electronic commerce.

Exhibit 8. Electronic commerce topologies

Topology	Internet	Intranet	Extranet
Extent	Global	Organizational	Business partnership
Focus	Stakeholder relationships	Employee information and communication	Distribution channel communication

The Internet is a global network of networks. Any computer connected to the Internet can communicate with any server in the system (see Exhibit 5). Thus, the Internet is well-suited to communicating with a wide variety of stakeholders. Adobe, for example, uses its Web site to distribute software changes to customers and provide financial and other reports to investors.

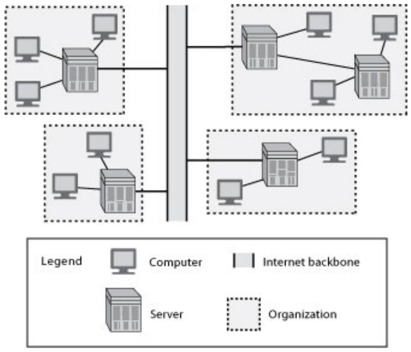

Exhibit 9.: The Internet

Many organizations have realized that Internet technology can also be used to establish an intra-organizational network that enables people within the organization to communicate and cooperate with each other. This so-called intranet (see Exhibit 10) is essentially a fenced-off mini-Internet within an organization. A firewall (see See Firewall) is used to restrict access so that people outside the organization cannot access the intranet. While an intranet may not directly facilitate cooperation with external stakeholders, its ultimate goal is to improve an organization's ability to serve these stakeholders.

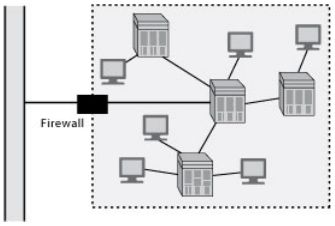

Exhibit 10.: An Intranet

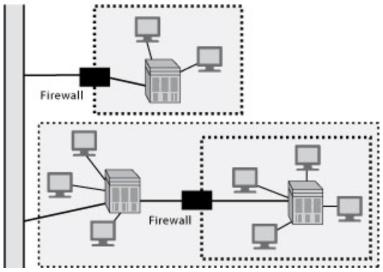

Exhibit 11.: An extranet

The Internet and intranet, as the names imply, are networks. That is, an array of computers can connect to each other. In some situations, however, an organization may want to restrict connection capabilities. An extranet (see Exhibit 7) is designed to link a buyer and supplier to facilitate greater coordination of common activities. The idea of an extranet derives from the notion that each business has a value chain and the end-point of one firm's chain links to the beginning of another's. Internet technology can be used to support communication and data transfer between two value chains. Communication is confined to the computers linking the two organizations. An organization can have multiple extranets to link it with many other organizations, but each extranet is specialized to support partnership coordination.

The economies gained from low-cost Internet software and infrastructure mean many more buyers and supplier pairs can now cooperate electronically. The cost of linking using Internet technology is an order of magnitude lower than using commercial communication networks for electronic data interchange (EDI) , the traditional approach for electronic cooperation between business partners.

EDI

EDI, which has been used for some 20 years, describes the electronic exchange of standard business documents between firms. A structured, standardized data format is used to exchange common business documents (e.g., invoices and shipping orders) between trading partners. In contrast to the free form of e-mail messages, EDI supports the exchange of repetitive, routine business transactions. Standards mean that routine electronic transactions can be concise and precise. The main standard used in the U.S. and Canada is known as ANSI X.12, and the major international standard is EDIFACT. Firms following the same standard can electronically share data. Before EDI, many standard messages between partners were generated by computer, printed, and mailed to the other party, that then manually entered the data into its computer. The main advantages of EDI are:

- paper handling is reduced, saving time and money;
- data are exchanged in real time;
- there are fewer errors since data are keyed only once;
- enhanced data sharing enables greater coordination of activities between business partners;
- money flows are accelerated and payments received sooner.

Despite these advantages, for most companies EDI is still the exception, not the rule. A recent survey in the United States showed that almost 80 percent of the information flow between firms is on paper. Paper should be the exception, not the rule. Most EDI traffic has been handled by value-added networks (VANs) or private networks. VANs add communication services to those provided by common carriers (e.g., AT&T in the U.S. and Telstra in Australia). However, these networks are too expensive for all but the largest 100,000 of the 6 million businesses in existence today in the United States. As a result, many businesses have not been able to participate in the benefits associated with EDI. However, the Internet will enable these smaller companies to take advantage of EDI.

Internet communication costs are typically less than with traditional EDI. In addition, the Internet is a global network potentially accessible by nearly every firm. Consequently, the Internet is displacing VANs as the electronic transport path between trading partners.

The simplest approach is to use the Internet as a means of replacing a VAN by using a commercially available Internet EDI package. EDI, with its roots in the 1960s, is a system for exchanging text, and the opportunity to use the multimedia capabilities of the Web is missed if a pure replacement strategy is applied. The multimedia capability of the Internet creates an opportunity for new applications that spawn a qualitatively different type of information exchange within a partnership. Once multimedia capability is added to the information exchange equation, then a new class of applications can be developed (e.g., educating the other partner about a firm’s purchasing procedures).

Security

Security is an eternal concern for organizations as they face the dual problem of protecting stored data and transported messages. Organizations have always had sensitive data to which they want to limit access to a few authorized people. Historically, such data have been stored in restricted areas (e.g., a vault) or encoded. These methods of restricting access and encoding are still appropriate.

Electronic commerce poses additional security problems. First, the intent of the Internet is to give people remote access to information. The system is inherently open, and traditional approaches of restricting access by the use of physical barriers are less viable, though organizations still need to restrict physical access to their servers. Second, because electronic commerce is based on computers and networks, these same technologies can be used to attack security systems. Hackers can use computers to intercept network traffic and scan it for confidential information. They can use computers to run repeated attacks on a system to breach its security (e.g., trying all words in the dictionary for an account’s password).

Access control

Data access control , the major method of controlling access to stored data, often begins with some form of visitor authentication, though this is not always the case with the Web because many organizations are more interested in attracting rather than restricting visitors to their Web site. A variety of authentication mechanisms may be used (see Exhibit 12). The common techniques for the Internet are account number, password, and IP address.

Exhibit 12. Authentication mechanisms

Class	Examples

Personal memory	Name, account number, password
Possessed object	Badge, plastic card, key, IP address
Personal characteristic	Fingerprint, voiceprint, signature, hand size

Firewall

A system may often use multiple authentication methods to control data access, particularly because hackers are often persistent and ingenious in their efforts to gain unauthorized access. A second layer of defense can be a firewall , a device (e.g., a computer) placed between an organization's network and the Internet. This barrier monitors and controls all traffic between the Internet and the intranet. Its purpose is to restrict the access of outsiders to the intranet. A firewall is usually located at the point where an intranet connects to the Internet, but it is also feasible to have firewalls within an intranet to further restrict the access of those within the barrier.

There are several approaches to operating a firewall. The simplest method is to restrict traffic to packets with designated IP addresses (e.g., only permit those messages that come from the University of Georgia–i.e., the address ends with uga.edu). Another screening rule is to restrict access to certain applications (e.g., Web pages). More elaborate screening rules can be implemented to decrease the ability of unauthorized people to access an intranet.

Implementing and managing a firewall involves a tradeoff between the cost of maintaining the firewall and the loss caused by unauthorized access. An organization that simply wants to publicize its products and services may operate a simple firewall with limited screening rules. Alternatively, a firm that wants to share sensitive data with selected customers may install a more complex firewall to offer a high degree of protection.

Coding

Coding or encryption techniques, as old as writing, have been used for thousands of years to maintain confidentiality. Although encryption is primarily used for protecting the integrity of messages, it can also be used to complement data access controls. There is always some chance that people will circumvent authentication controls and gain unauthorized access. To counteract this possibility, encryption can be used to obscure the meaning of data. The intruder cannot read the data without knowing the method of encryption and the key.

Societies have always needed secure methods of transmitting highly sensitive information and confirming the identity of the sender. In an earlier time, messages were sealed with the sender's personal signet ring–a simple, but easily forged, method of authentication. We still rely on personal signatures for checks and legal contracts, but how do you sign an e-mail message? In the information age, we need electronic encryption and signing for the orderly conduct of business, government, and personal correspondence.

Internet messages can pass through many computers on their way from sender to receiver, and there is always the danger that a sniffer program on an intermediate computer briefly intercepts and reads a message. In most cases, this will not cause you great concern, but what happens if your message contains your name, credit card number, and expiration date? The sniffer program, looking for a typical credit card number format of four blocks of four digits (e.g., 1234 5678 9012 3456), copies your message before letting it continue its normal progress. Now, the owner of the rogue program can use your credit card details to purchase products in your name and charge them to your account.

Without a secure means of transmitting payment information, customers and merchants will be very reluctant to place and receive orders, respectively. When the customer places an order, the Web browser should automatically encrypt the order prior to transmission–this is not the customer's task.

Credit card numbers are not the only sensitive information transmitted on the Internet. Because it is a general transport system for electronic information, the Internet can carry a wide range of confidential information (financial reports, sales figures, marketing strategies, technology reports, and so on). If senders and receivers cannot be sure that their communication is strictly private, they will not use the Internet. Secure transmission of information is necessary for electronic commerce to thrive.

Encryption

Encryption is the process of transforming messages or data to protect their meaning. Encryption scrambles a message so that it is meaningful only to the person knowing the method of encryption and the key for deciphering it. To everybody else, it is gobbledygook. The reverse process, decryption, converts a seemingly senseless character string into the original message. A popular form of encryption, readily available to Internet users, goes by the name of Pretty Good Privacy (PGP) and is distributed on the Web. PGP is a public domain implementation of public-key encryption.

Traditional encryption, which uses the same key to encode and decode a message, has a very significant problem. How do you securely distribute the key? It can't be sent with the message because if the message is intercepted, the key can be used to decipher it. You must find another secure medium for transmitting the key. So, do you fax the key or phone it? Either method is not completely secure and is time-consuming whenever the key is changed. Also, how do you know that the key's receiver will protect its secrecy?

A public-key encryption system has two keys: one private and the other public. A public key can be freely distributed because it is quite separate from its corresponding private key. To send and receive messages, communicators first need to create separate pairs of private and public keys and then exchange their public keys. The sender encrypts a message with the intended receiver's public key, and upon receiving the message, the receiver applies her private key (see Exhibit 13). The receiver's private key, the only one that can decrypt the message, must be kept secret to permit secure message exchange.

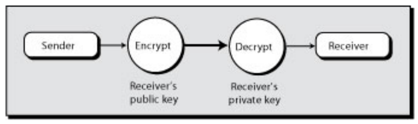

Exhibit 13.: Encryption with a public-key system

The elegance of the public-key system is that it totally avoids the problem of secure transmission of keys. Public keys can be freely exchanged. Indeed, there can be a public database containing each person's or organization's public key. For instance, if you want to e-mail a confidential message, you can simply obtain the sender's public key and encrypt your entire message prior to transmission.

Exhibit 14: Message before encryption

To: George Zinkhan <gzinkhan@cbacc.cba.uga.edu> From: Rick Watson <rwatson@uga.edu> Subject: Money—————————————— G'day George I hope you are enjoying your stay in Switzerland. Could you do me a favor? I need USD 50,000 from my secret Swiss bank account. The name of the bank is Aussie-Suisse International in Geneva. The account code is 451-3329 and the password is `meekatharra' I'll see you (and the money) at the airport this Friday. Cheers
Rick

Consider the message shown in Exhibit 10; the sender would hardly want this message to fall into the wrong hands. After encryption, the message is totally secure (see Exhibit 15). Only the receiver, using his private key, can decode the message.

Exhibit 15: Message after encryption

To: George Zinkhan <gzinkhan@cbacc.cba.uga.edu> From: Rick Watson <rwatson@uga.edu> Subject: Money——————————————-BEGIN PGP MESSAGE—- Version: 2.6.2
hEwDfOTG8eEvuiEBAf9rxBdHpgdq1g0gaIP7zm1OcHvWHtx 9 ip27q6vI
tjYbIUKDnGjV0sm2INWpcohrarI9S2xU6UcSPyFfumGs9pgAAAQ0euRGjZY RgIPE5DUHG
uItXYsnIq7zFHVevjO2dAEJ8ouaIX9YJD8kwp4T3suQnw7/d 1j4edl46qisrQHpRRwqHXons7w4k04x8tH4JGfWEXc5LB
hcOSyPHEir4EP qDcEPlblM9bH6 w2ku2fUmdMaoptnVSinLMtzSqIKQlHMfaJ0HM9Df4kWh
ZbY0yFXxSuHKrgbaoDcu9wUze35dtwiCTdf1sf3ndQNaLOFiIjh5pis bUg 9rOZjxpEFbdGgYpcfBB4rvRNwOwizvSodxJ9H
VdtAL3DIsSJdNSAEuxjQ0 hvOSA8oCBDJfHSUFqX3ROtB3 yuT1vf/C8Vod4gW4tvqj8C1QNte ehxg== =fD44—-END PGP MESSAGE—-

Signing

In addition, a public-key encryption system can be used to authenticate messages. In cases where the content of the message is not confidential, the receiver may still wish to verify the sender's identity. For example, one of your friends may find it amusing to have some fun at your expense (see Exhibit 16).

Exhibit 16: Message before signing

To: Rick Watson <rwatson@uga.edu> From: President@whitehouse.gov Subject: Invitation to visit the White House———————————————— Dear Dr. Watson It is my pleasure to invite you to a special meeting of Internet users at the White House on April 1st at 2pm. Please call 212-123-7890 and ask for Mr. A. Phool for complete details of your visit. The President

If the President indeed were in the habit of communicating electronically, it is likely that he would sign his messages so that the receiver could verify it. A sender's private key is used to create a signed message . The receiver then applies the sender's public key to verify the signature (see Exhibit 17).

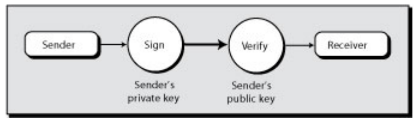

Exhibit 17.: Signing with a public-key system

A signed message has additional encrypted text containing the sender's signature (see Exhibit 18). When the purported sender's public key is applied to this message, the identity of the sender can be verified (it was not the President).

Exhibit 18: Message after signing

To: Rick Watson <rwatson@uga.cc.uga.edu> From: President@whitehouse.gov Subject: Invitation to visit the White House———————————————— Dear Dr. Watson It is my pleasure to invite you to a special meeting of Internet users at the White House on April 1st at 2pm. Please call 212-123-7890 and ask for Mr. A. Phool for complete details of your visit. The President—-BEGIN PGP SIGNATURE—- Version: 2.6.2 iQCVAwUBMeRVVUblZxMqZR69AQFJNQQAwHMSrZhWyiGTieGukbhPGUNF3aB qm7E8g5ySsY6QqUcg2zwUr40w8Q0Lfcc4nmr0NUujiXkqzTNb 3RL41w5x fTCfMp1Fi5Hawo829UQAlmN8L5hzl7XfeON5WxfYcxLGXZcbUWkGio6/d4r 9Ez6s79DDf9EuDlZ4qfQcy1iA==G6jB —-END PGP SIGNATURE—-

Imagine you pay USD 1,000 per year for an investment information service. The provider might want to verify that any e-mail requests it receives are from subscribers. Thus, as part of the subscription sign-up, subscribers have to supply their public key, and when using the service, sign all electronic messages with their private key. The provider is then assured that it is servicing paying customers. Naturally, any messages between the service and the client should be encrypted to ensure that others do not gain from the information.

Electronic money

When commerce goes electronic, the means of paying for goods and services must also go electronic. Paper-based payment systems cannot support the speed, security, privacy, and internationalization necessary for electronic commerce. In this section, we discuss four methods of electronic payment:

- electronic funds transfer
- digital cash
- ecash
- credit card

There are four fundamental concerns regarding electronic money: security , authentication, anonymity, and divisibility. Consumers and organizations need to be assured that their on-line orders are protected, and organizations must be able to transfer securely many millions of dollars. Buyers and sellers must be able to verify that the electronic money they receive is real; consumers must have faith in electronic currency. Transactions, when required, should remain confidential. Electronic currency must be spendable in small amounts (e.g., less than one-tenth of a cent) so that high-volume, small-value Internet transactions are feasible (e.g., paying 0.1 cent to read an article in an encyclopedia). The various approaches to electronic money vary in their capability to solve these concerns (see Exhibit 19).

Exhibit 19. Characteristics of electronic money

	Security	Authentication	Anonymity	Divisibility

EFT	High	High	Low	Yes
Digital cash	Medium	High	High	Yes
Ecash	High	High	High	Yes
Credit card	High	High	Low	Yes

Any money system, real or electronic, must have a reasonable level of security and a high level of authentication, otherwise people will not use it. All electronic money systems are potentially divisible. There is a need, however, to adapt some systems so that transactions can be automated. For example, you do not want to have to type your full credit card details each time you spend one-tenth of a cent. A modified credit card system, which automatically sends previously stored details from your personal computer, could be used for small transactions.

The technical problems of electronic money have not been completely solved, but many people are working on their solution because electronic money promises efficiencies that will reduce the costs of transactions between buyers and sellers. It will also enable access to the global marketplace. In the next few years, electronic currency will displace notes and coins for many transactions.

Electronic funds transfer

Electronic funds transfer (EFT), introduced in the late 1960s, uses the existing banking structure to support a wide variety of payments. For example, consumers can establish monthly checking account deductions for utility bills, and banks can transfer millions of dollars. EFT is essentially electronic checking. Instead of writing a check and mailing it, the buyer initiates an electronic checking transaction (e.g., using a debit card at a point-of-sale terminal). The transaction is then electronically transmitted to an intermediary (usually the banking system), which transfers the funds from the buyer's account to the seller's account. A banking system has one or more common clearinghouses that facilitate the flow of funds between accounts in different banks.

Electronic checking is fast; transactions are instantaneous. Paper handling costs are substantially reduced. Bad checks are no longer a problem because the seller's account balance is verified at the moment of the transaction. EFT is flexible; it can handle high volumes of consumer and commercial transactions, both locally and internationally. The international payment clearing system, consisting of more than 100 financial institutions, handles more than one trillion dollars per day.

The major shortfall of EFT is that all transactions must pass through the banking system, which is legally required to record every transaction. This lack of privacy can have serious consequences.7 Cash gives anonymity.

Digital cash

Digital cash is an electronic parallel of notes and coins. Two variants of digital cash are presently available: prepaid cards and smart cards. The phonecard, the most common form of prepaid card, was first issued in 1976 by the forerunner of Telecom Italia. The problem with special-purpose cards, such as phone and photocopy cards, is that people end up with a purse or wallet full of cards. A smart card combines many functions into one card. A smart card can serve as personal identification, credit card, ATM card, telephone credit card, critical medical information record and as cash for small transactions. A smart card, containing memory and a microprocessor, can store as much as 100 times more data than a magnetic-stripe card. The microprocessor can be programmed.

The stored-value card, the most common application of smart card technology, can be used to purchase a wide variety of items (e.g,. fast food, parking, public transport tickets). Consumers buy cards of standard denominations (e.g., USD 50 or USD 100) from a card dispenser or bank. When the card is used to pay for an item, it must be inserted in a reader. Then, the amount of the transaction is transferred to the reader, and the value of the card is reduced by the transaction amount.

The problem with digital cash, like real cash, is that you can lose it or it can be stolen. It is not as secure as the other alternatives, but most people are likely to carry only small amounts of digital cash and thus security is not so critical. As smart cards are likely to have a unique serial number, consumers can limit their loss by reporting a stolen or misplaced smart card to invalidate its use. Adding a PIN number to a smart card can raise its security level.

Twenty million smart cards are already in use in France, where they were introduced a decade earlier. In Austria, 2.5 million consumers carry a card that has an ATM magnetic stripe as well as a smart card chip. Stored-value cards are likely to be in widespread use in the United States within five years. Their wide-scale adoption could provide substantial benefits. Counting, moving, storing and safeguarding cash is estimated to be 4 percent of the value of all transactions. There are also significant benefits to be gained because banks don't have to hold as much cash on hand, and thus have more money available for investment.

Ecash

Digicash of Amsterdam has developed an electronic payment system called ecash that can be used to withdraw and deposit electronic cash over the Internet. The system is designed to provide secure payment between computers using e-mail or the Internet. Ecash can be used for everyday Internet transactions, such as buying software, receiving money from parents, or paying for a pizza to be delivered. At the same time, ecash provides the privacy of cash because the payer can remain anonymous.

To use ecash, you need a digital bank account and ecash client software. The client is used to withdraw ecash from your bank account, and store it on your personal computer. You can then spend the money at any location accepting ecash or send money to someone who has an ecash account.

The security system is based on public-key cryptography and passwords. You need a password to access your account and electronic transactions are encrypted.

Credit card

Credit cards are a safe, secure, and widely used remote payment system. Millions of people use them every day for ordering goods by phone. Furthermore, people think nothing of handing over their card to a restaurant server, who could easily find time to write down the card's details. In the case of fraud in the U.S., banks already protect consumers, who are typically liable for only the first USD 50. So, why worry about sending your credit card number over the Internet? The development of secure servers and clients has made transmitting credit card numbers extremely safe. The major shortcoming of credit cards is that they do not support person-to-person transfers and do not have the privacy of cash.

Secure electronic transactions

Electronic commerce requires participants to have a secure means of transmitting the confidential data necessary to perform a transaction. For instance, banks (which bear the brunt of the cost of credit card fraud) prefer credit card numbers to be hidden from prying electronic eyes. In addition, consumers want assurance that the Web site with which they are dealing is not a bogus operation. Two forms of protecting electronic transactions are SSL and SET.

SSL

Secure Sockets Layer (SSL) was created by Netscape for managing the security of message transmissions in a network. SSL uses public-key encryption to encode the transmission of secure messages (e.g., those containing a credit card number) between a browser and a Web server.

The client part of SSL is part of Netscape's browser. If a Web site is using a Netscape server, SSL can be enabled and specific Web pages can be identified as requiring SSL access. Other servers can be enabled by using Netscape's SSLRef program library, which can be downloaded for noncommercial use or licensed for commercial use.

SET

Secure Electronic Transaction (SET) is a financial industry innovation designed to increase consumer and merchant confidence in electronic commerce. Backed by major credit card companies, MasterCard and Visa, SET is designed to offer a high level of security for Web-based financial transactions. SET should reduce consumers' fears of purchasing over the Web and increase use of credit cards for electronic shopping. A proposed revision, due in 1999, will extend SET to support business-to-business transactions, such as inventory payments.

Visa and MasterCard founded SET as a joint venture on February 1, 1996. They realized that in order to promote electronic commerce, consumers and merchants would need a secure, reliable payment system. In addition, credit card issuers sought the protection of more advanced anti-fraud measures. American Express has subsequently joined the venture.

SET is based on cryptography and digital certificates. Public-key cryptography ensures message confidentiality between parties in a financial transaction. Digital certificates uniquely identify the parties to a transaction. They are issued by banks or clearinghouses and kept in registries so that authenticated users can look up other users' public keys.

Think of a digital certificate as an electronic credit card. It contains a person's name, a serial number, expiration date, a copy of the certificate holder's public key (used for encrypting and decrypting messages and verifying digital signatures), and the digital signature of the certificate-issuing authority so that a recipient can verify that the certificate is real. A digital signature is used to guarantee a message sender's identity.

The SET components

Cardholder wallet

The application on the cardholder's side is also called the digital wallet . This software plug-in contains a consumer's digital certificate, shipping and other account information. This critical information is protected by a password, which the owner must supply to access the stored data. In effect, an electronic wallet stores a digital representation of a person's credit card and enables electronic transactions.

Merchant server

On the merchant side, a merchant server accepts electronic credit card payments.

Payment gateway

The payment gateway is the bridge between SET and the existing payment network. A payment gateway application translates SET messages for the existing payment system to complete the electronic transaction.

Certificate authority

The certificate authority issues and manages digital certificates, which are proofs of the identities for all parties involved in a SET transaction.

The process

The following set of steps illustrates SET in action.

- The customer opens a MasterCard or Visa account with a bank.
- The customer receives a digital certificate (an electronic file), which functions as a credit card for on-line transactions. The certificate includes a public key with an expiration date and has been digitally signed by the bank to ensure its validity.
- Third-party merchants also receive digital certificates from the bank. These certificates include the merchant's public key and the bank's public key.
- The customer places an electronic order from a merchant's Web page.
- The customer's browser receives and confirms that the merchant's digital certificate is valid.
- The browser sends the order information. This message is encrypted with the merchant's public key, the payment information, which is encrypted with the bank's public key (which can't be read by the merchant), and information that ensures the payment can be used only with the current order.
- The merchant verifies the customer by checking the digital signature on the customer's certificate. This may be done by referring the certificate to the bank or to a third-party verifier.
- The merchant sends the order message along to the bank. This includes the bank's public key, the customer's payment information (which the merchant can't decode), and the merchant's certificate.
- The bank verifies the merchant and the message. The bank uses the digital signature on the certificate with the message and verifies the payment part of the message.
- The bank digitally signs and sends authorization to the merchant, who can then fill the order.
- The customer receives the goods and a receipt.
- The merchant gets paid according to its contract with its bank.
- The customer gets a monthly bill from the bank issuing the credit card.

The advantage of SET is that a consumer's credit card number cannot be deciphered by the merchant. Only the bank and card issuer can decode this number. This facility provides an additional level of security for consumers, banks, and credit card issuers, because it significantly reduces the ability of unscrupulous merchants to establish a successful Web presence.

In order to succeed, SET must displace the current standard for electronic transactions, SSL, which is simpler than SET but less secure. Because of SSL's simplicity, it is expected to provide tough competition, and may remain the method of choice for the interface between the on-line buyer and the merchant. The combination of SSL and fraud-detection software has so far provided low-cost, adequate protection for electronic commerce.

Cookies

The creator of a Web site often wants to remember facts about you and your visit. A cookie is the mechanism for remembering details of a single visit or store facts between visits. A cookie is a small file (not more than 4k) stored on your hard disk by a Web application. Cookies have several uses.

- Visit tracking: A cookie might be used to determine which pages a person views on a particular Web site visit. The data collected could be used to improve site design.
- Storing information: Cookies are used to record personal details so that you don't have to supply your name and address details each time you visit a particular site. Most subscription services (e.g., The Wall Street Journal) and on-line stores (e.g., Amazon.com) use this approach.
- Customization: Some sites use cookies to customize their service. A cookie might be used by CNN to remember that you are mainly interested in news about ice skating and cooking.
- Marketing: A cookie can be used to remember what sites you have visited so that relevant advertisements can be supplied. For example, if you frequently visit travel sites, you might get a banner ad from Delta popping up next time you do a search.

Cookies are a useful way of collecting data to provide visitors with better service. Without accurate information about people's interest, it is very difficult to provide good service.

Both Internet Explorer and Netscape Navigator allow surfers to set options for various levels of warnings about the use of cookies. Visitors who are concerned about the misuse of cookies can reject them totally, with the consequent loss of service.

Conclusion

The rapid growth of electronic commerce is clear evidence of the reliability and robustness of the underlying technology. Many of the pieces necessary to facilitate electronic commerce are mature, well-tested technologies, such as public-key encryption. The future is likely to see advances that make electronic commerce faster, less expensive, more reliable, and more secure.

Cases

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CHAPTER OVERVIEW

11: Business and Sustainability

11.1: Energy and Materials- New Challenges in the First Decade of the Twenty-first Century and Limits to the Conventional Growth Model

11.2: Defining Sustainability Innovation

11.1: Energy and Materials- New Challenges in the First Decade of the Twenty-first Century and Limits to the Conventional Growth Model

Learning Objectives

1. Appreciate the scope and complexity of the challenges that have recently spurred sustainability innovation with respect to energy and materials.
2. Gain insight into the fundamental drivers creating opportunities for entrepreneurs and new ventures in the sustainability innovation arena.

Sustainability innovators create new products and services designed to solve the problems created by the collision of economic growth, population growth, and natural systems. They seek integrated solutions that offer financial renumeration, ecological system protection, and improved human health performance, all of which contribute to community prosperity. Sustainability innovation, growing from early ripples of change in the 1980s and 1990s, now constitutes a wave of creativity led by a growing population of entrepreneurial individuals and ventures. This form of creativity applies to raw materials selection, energy use, and product design as well as company strategies across supply chains. It encompasses renewable energy technologies to reduce pollution and climate impacts as well as the safer design of molecular materials used in common household products. Today's tough economic times and need for job creation, while seemingly detracting from environmental concerns, in fact underscore the importance of monitoring energy and material input and waste cost-reduction measures; these are made visible through a sustainability lens. In addition, because the environmental health and ecological system degradation issues will only increase with economic growth, and public concern is unlikely to fade, those firms that explore sustainability efficiencies and differentiation opportunities now will be better positioned to weather the economic downturn.

Research indicates that individuals and ventures that pursue these objectives often work through networks of diverse supply-chain collaborations to realize new and better ways of providing goods and services. As a result, a plethora of substitute products, technologies, and innovative ways of organizing that address pollution, health, resource use, and equity concerns are being introduced and tested in the marketplace. This is the challenge and the excitement of sustainability innovation. In this chapter we look more closely at sustainability innovation. What forces have driven it, and how is it being defined?

Two areas, energy and materials, provide useful entry points for exploring why businesses are increasingly using sustainability frameworks for thinking about the redesign of their products and operations. However, in the first decade of the twenty-first century, the media and public increasingly focused on climate change as the top environmental issue. Severe storms and other extreme weather patterns predicted by climate change scientists had become more evident. Hurricane Katrina in New Orleans, accelerated Arctic and Antarctic warming, rising ocean levels, and increasing carbon dioxide (CO2) concentrations were discussed widely in the scientific reports and the mainstream media as examples of how human actions shaped natural systems' dynamics. At the biological level, accumulating industrial chemicals in adults' and children's bodies were reported as one of the wide-ranging examples of system equilibrium disruptions. There was growing discussion of tipping points and ways to contain change within an acceptable range of variation for continued human prosperity.

Partly in response to this growing concern, globally and within nation-states, markets for carbon; clean and more efficient energy; and safer, cleaner products have grown rapidly. These markets will continue to expand given economic growth trajectories, the rapid movement of more people into a global middle class, and the constrained capacities of natural systems, including our bodies, to absorb the impacts.

While some hear only negative news in these words, entrepreneurs and innovators typically do not spend much time on the negative messages. They use innovation to create alternatives. They envision new and better possibilities. They take action to address perceived inefficiencies and to solve problems. Health and environmental problems, the inefficiencies related to pollution, and the newly understood health threats are viewed as opportunities for entrepreneurially minded individuals and ventures to offer substitutes.

The shift in perception about industrial and commercial pollution and adverse impacts has been augmented by a new appreciation of the scale and scope of human activity. For example, a short time ago pollution was considered a manageable local problem (and even a visible indicator of economic progress). Today our scientific knowledge has advanced to see not just visible acute pollution challenges as health problems but also molecular depositions far from their source; in other words, problems stretching across local, regional, and even global scales are major unintended effects of industrialization.

Changes in the Character of the Ecological and Health Challenges, Pre-1980s versus Post-1980s

Pre-1980s	Post-1980s
Minor	Systemic
Localized	Global
Dispersed and separate	Tightly coupled
Simple	Complex
Isolated	Ubiquitous
Stable and visible	Turbulent and hard to discern
Slow-moving	Accelerated

By 2010 there was a scientific and policy acknowledgement about the physical impossibility of maintaining ecosystems' stability in the face of the existing and the anticipated scale and scope of pollution levels. A biosphere that seemed a short time ago to be infinite in its capacity to absorb waste and provide ecosystem services showed growing evidence of limits. Thus today, satisfying the legitimate material and energy demands of billions of upwardly mobile people in the global community, without severely disrupting ecosystem functions and exacting harsh human costs, is a first-order challenge for economic and business design. This problem is soluble, but it requires creativity that reaches beyond conventional thinking to imagine new models for economic growth and for business. In fact, in increasing numbers companies are now adopting sustainability principles in their product designs and strategies. Recognizing the problem-complexity shift represented by the second column in Table 2.1, companies are taking on what can be called a sustainability view of their world. The changes under way are captured in Table 2.2, which compares the old business approach, defined by more narrowly framed environmental issues, and leading entrepreneurial innovators' perspectives on sustainability challenges.

Traditional View versus Sustainability View

Traditional view	Sustainability view
Rhetoric and greenwash	Operational excellence
Cost burden	Efficiencies
Compliance	Cost competitiveness/strategic advantage
Doing good/altruism	Strong financial performance
Peripheral to the business	Core to the business
Technology fix	Frameworks, tools, and programs
Reactive	Innovative and entrepreneurial

Let's start at a more macro level of analysis that allows us to track the reframing of what historically have been called environmental concerns. To better understand the functioning and interdependencies of the natural and human-created systems of which we are a part, we can look at basic energy and material flows. Even a cursory look reveals some of the major challenges. Fossil fuel energy consumption is closely linked to local and global climate modification, ocean acidification (and consequently coral reef degradation that undermines ocean food supplies), and ground-level air pollution, among other problems. Materials extraction and use are tightly coupled with unprecedented waste disposal challenges and dispersed toxins. Furthermore, in our search for energy and materials to fuel economic growth and feed more people, we have been systematically eliminating the habitat and ecosystems on which our future prosperity depends.

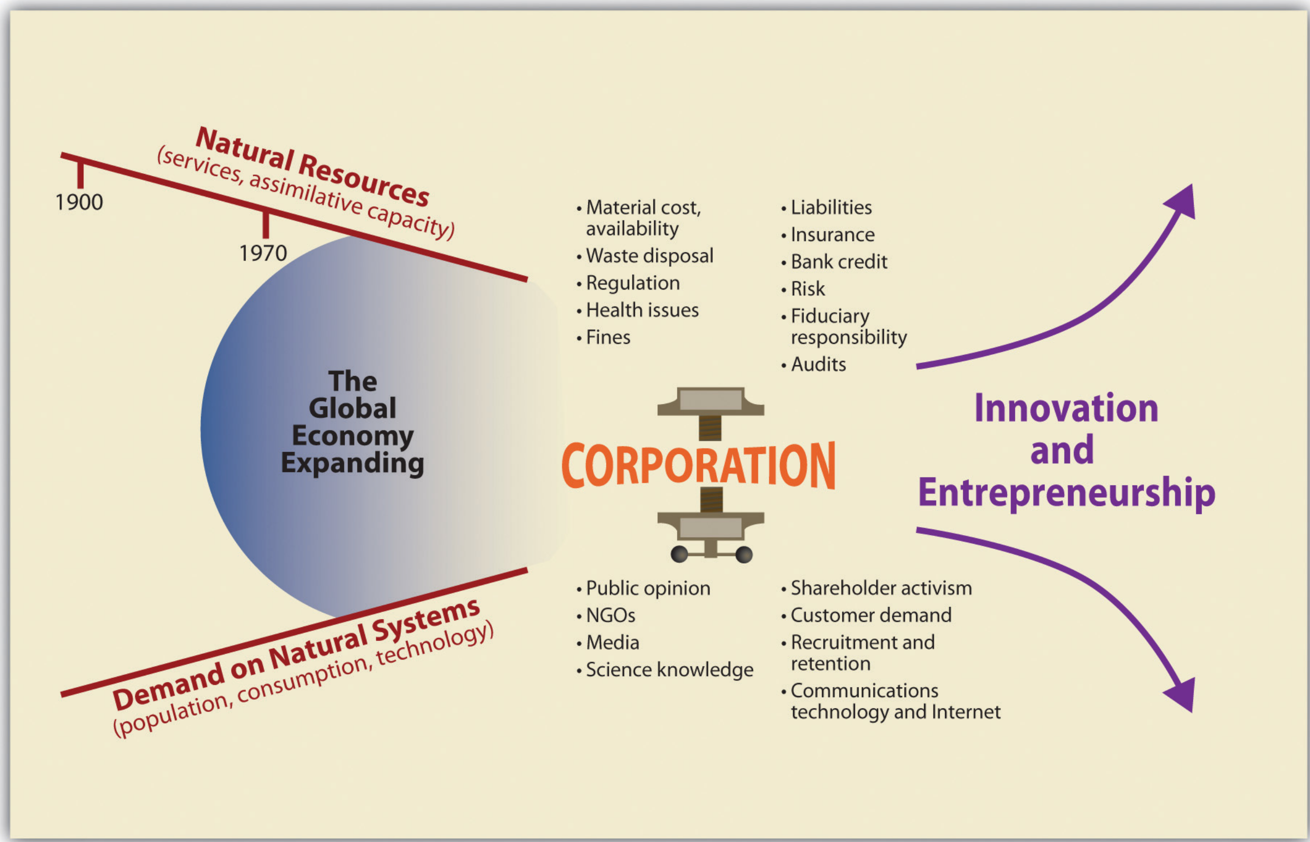


Figure 11.1.1: Changing Conditions for Business. Source: Adapted from The Natural Step 2005.

> In 1900 a business did not have to think about its impact on the larger natural world. However, with population growth, a rapidly expanding global economy, and greater transparency demanded from civil society, firms feel increasing pressure to adapt to a more constrained physical world. The existing business model is being challenged by entrepreneurial innovations offering different ways of thinking about business in society. Thus, by studying sustainability innovation, we are able to look at alternative business models for the future.

Americans have long voiced support for environmental issues in public opinion polls. That concern has grown, especially as human-influenced climate change became increasingly apparent and a harbinger of broader ecological and health challenges. Even as the US economy faltered dramatically in late 2008, 41 percent of respondents to a survey for the Pew Research Center stated in January 2009 that the environment should remain the president's top priority, while 63 percent thought the same when President Bush was in office in 2001.Pew Research Center for the People and the Press, "Economy, Jobs Trump All Other Policy Priorities in 2009," news release, January 22, 2009, accessed March 27, 2009, http://people-press.org/report/485/economy-top-policy-priority. In a different series of polls conducted by Pew between June 2006 and April 2008, over 70 percent of Americans consistently said there is "solid evidence" that global warming is occurring, and between 41 and 50 percent said human activity is the main cause. Independents and Democrats were one and one-half times to twice as likely as Republicans to agree to the statements, indicating ongoing political divisions over the credibility or impartiality of science and how it should inform our response to climate change.Pew Research Center for the People and the Press, "A Deeper Partisan Divide over Global Warming," news release, May 8, 2008, accessed March 27, 2009, people-press.org/reports/pdf/417.pdf. Regardless of climate change public opinion polls, however, by 2010 energy issues had gained national attention for an ever-broadening set of reasons.

In fact, by 2010 climate change often was linked to energy independence and energy efficiency as the preferred strategy to get both liberals and conservatives to address global warming. This approach emphasized saving money by saving energy and deploying innovative technology rather than relying on federal mandates and changes to social behavior to curb emissions. The federal government was asked to do more under President Obama. Energy independence included reduced reliance on imported oil as well as nurturing renewable energy and technologies and local solutions to electricity, heating and cooling, and transportation needs.

The Energy Security and Independence Act of 2007, among other things, increased fuel economy standards for cars, funded green job training programs, phased out incandescent light bulbs, and committed new and renovated federal buildings to being carbon-neutral by 2030.

Meanwhile, renewable energy sources continue to inch upward. By 2007, just over 71 quadrillion British thermal units of energy were produced in total in the United States. About 9.5 percent of that energy came from renewable sources: hydroelectric (dams), geothermal, solar, wind, and wood or other biomass. Indeed, wood and biomass accounted for about 52 percent of all renewable energy production, while hydroelectric power represented another 36 percent. Wind power represented about 5 percent of renewable energy and solar 1 percent.Energy Information Administration, Department of Energy, "Table 1.2: Primary Energy Production by Source, 1949–2009," Annual Energy Review, accessed March 27, 2009, www.eia.doe.gov/emeu/aer/txt/ptb0102.html. The numbers were relatively small, but each of these markets was experiencing double-digit growth rates, offering significant opportunities to investors, entrepreneurs, and firms that wanted to contribute to cleaner energy and reduced fossil fuel dependence.

In fact, climate change took center stage among environmental issues in the first decade of this century, with public awareness of climate change heightened by unusual weather patterns. Hurricane Katrina, which devastated New Orleans in 2005, was interpreted as a sign of worse storms to come. The Intergovernmental Panel on Climate Change (IPCC) released its Fourth Assessment Report in 2007. This report affirmed global climate change was largely anthropogenic (caused by human activity) and indicated that change was occurring more rapidly than anticipated. Almost a doubling of the rate of sea level rise was recorded from 1993 to 2003 compared to earlier rates, and a steady increase in the ocean's acidity was verified.Rajendra K. Pachauri, and Andy Reisinger, eds. (core writing team), Climate Change 2007: Synthesis Report (Geneva, Switzerland: Intergovernmental Panel on Climate Change, 2008), accessed November 30, 2010, http://www.ipcc.ch/publications_and_data/publications_ipcc_fourth_assessment_report_synthesis_report.htm. The ocean's pH decreased about 0.04 pH units from 1984 to 2005. Acidity is measured on a logarithmic scale from 0 to 14, with a one pH unit increase meaning a tenfold increase in acidity. The 2006 Stern Review on the Economics of Climate Change, commissioned by the Treasury of the United Kingdom, attempted to put a cost on the price of business as usual in the face of climate change. It estimated climate change could incur expenses equivalent to 5 to 20 percent of the global gross domestic product (GDP) in the coming decades if nothing changed in our practices, whereas acting now to mitigate the impact of climate change would cost only about 1 percent of global GDP. As the report concluded, "Climate change is the greatest market failure the world has ever seen."Sir Nicholas Stern, Stern Review on the Economics of Climate Change (London: HM Treasury, 2006), viii, accessed March 26, 2009, http://www.hm-treasury.gov.uk/sternreview_index.htm.

Also in 2007, former vice president Al Gore's documentary on climate change, An Inconvenient Truth, won an Oscar for best feature documentary, while Gore and the IPCC were jointly awarded the Nobel Peace Prize. Although debates over the science continued, the consensus of thousands of scientists worldwide that the atmospheric concentrations of CO2 were at least in part man-made firmly placed global climate and fossil fuel use on the agenda. National policies and the US military engagements related to securing and stabilizing oil imports and prices focused attention further on avoiding oil dependency. Indicating resource issues' close link to social conflicts, in 2008 the National Intelligence Estimate report from the CIA and other agencies warned climate change could trigger massive upheaval, whether from natural disasters and droughts that destabilized governments or increased flows of climate refugees, both the result of and cause of competition over resources and civil unrest.

Trailer for an inconvenient Truth

The 2006 film An Inconvenient Truth chronicles the perils of climate change and former US Vice President Al Gore's work to alert people to the danger.

www.climatecrisis.net/trailer.

The 2008 Olympic Games in Beijing, meanwhile, highlighted the increasing pollution from high-growth industrializing countries. That year China eclipsed the United States as the leading emitter of CO2, while Chinese officials had to take steps to prevent athletes and tourists from choking in Beijing's notorious smog. To reduce the worst vehicle emissions in the days leading up to the games, cars with even license plate numbers could drive one day, odd the next, and factories were shut down.Paul Kelso, "Olympics: Pollution over Beijing? Don't Worry, It's Only Mist, Say Officials," Guardian (London), August 6, 2008, accessed November 30, 2010, http://www.guardian.co.uk/sport/2008/aug/06/olympics2008.china; Talea Miller, "Beijing Pollution Poses Challenge to Olympic Athletes," PBS NewsHour, May 16, 2008, accessed November 30, 2010, www.pbs.org/newshour/indepth_coverage/asia/china/2008/athletes.html. India also has struggled to curb pollution as its industrialization accelerates. The World Bank estimated India’s natural resources will be more strained than any other country’s by 2020.“India and Pollution: Up to Their Necks in It,” Economist, July 17, 2008, accessed November 30, 2010, http://www.economist.com/world/asia/displaystory.cfm?story_ id=11751397.

To those living in a developed country, particularly in the United States where climate change continues to be debated, warming temperatures can seem somewhat abstract. The following links provide narratives and visual appreciation for how climate change actually influences many people around the world.

Bangladesh Migration Forced by Sea-Level Rise

http://www.guardian.co.uk/environment/video/2009/nov/30/bangladesh-climate-migration

A More General Travelogue (Nepal to Bangladesh) of Effects of Glacial Retreat on People

http://www.guardian.co.uk/environment/video/2009/dec/07/copenhagen-nepal-bangladesh

Glacier Melt in China Affects People

http://www.guardian.co.uk/environment/video/2008/jul/25/glacier.tian

Global Warming Affects Inuit in Canada

www.cbsnews.com/video/watch/?id=3181766n

Broad scientific consensus on climate change and its origin, the increased concentration of greenhouse gases (GHGs) in the atmosphere, has motivated hundreds of US cities, from Chicago to Charlottesville, to pledge to follow the Kyoto Protocol to reduce emissions within their municipalities through a variety of mechanisms including setting green building standards. The Kyoto Protocol is an international agreement among countries formally initiated in 1997 whose goal is to reduce (GHGs).

Figure 11.1.2: Bangladeshis Sandbagging Coastline. Source: “Environmental Geology of Developing Nations: Geology 351,” Department of Geological Sciences, California State University, Los Angles, accessed March 14, 2011, www.calstatela.edu/dept/geology/G351.htm.

This city movement is under way despite the eight-year oppositional position of President Bush’s administration and the Obama administration’s unsuccessful effort to promote a national carbon policy. States also took the lead on many other environmental issues, and according to the Pew Center on Global Climate Change, as of January 2009, twenty-nine states had mandatory renewable energy portfolio standards to encourage the growth of wind, solar, and other energy sources besides fossil fuels. This meant states set target dates at which some percentage (5 to 25 percent, for example) of the energy used within the state must come from renewable energy technology. Another six states had voluntary goals.Pew Center on Global Climate Change, “Renewable & Alternative Energy Portfolio Standards,” October 27, 2010, accessed November 30, 2010, www.pewclimate.org/what_s_being_done/in_the_states/rps.cfm. California’s 2006 Global Warming Solutions Act committed the state to reduce GHG emissions from stationary sources. In fall 2010, California voters affirmed the state’s comprehensive climate law designed to promote renewable energy, green-collar jobs, and lower emission vehicles, along with other advanced sustainability-focused technologies. Transportation is also a heavy contributor to CO2 emissions. Regulation of GHG emissions from vehicles may join a series of other regulations on mobile pollution sources. Since trading programs have succeeded in reducing nitrogen oxides and sulfur dioxide from stationary sources, vehicles have increased their relative contribution to acid rain and ground-level ozone, or smog. Each vehicle today may pollute less than its counterpart in 1970, but Americans have more cars and drive them farther, thus increasing total pollution from this sector. The US Environmental Protection Agency (EPA) acknowledges, "Transportation is also the fastest-growing source of GHGs in the U.S., accounting for 47 percent of the net increase in total U.S. emissions since 1990."US Environmental Protection Agency, Office of Transportation and Air Quality, "Transportation and Climate: Basic Information," last modified September 14, 2010, accessed November 30, 2010, www.epa.gov/OMS/climate/basicinfo.htm. Other countries have seen similar increases in vehicles and their associated pollution.

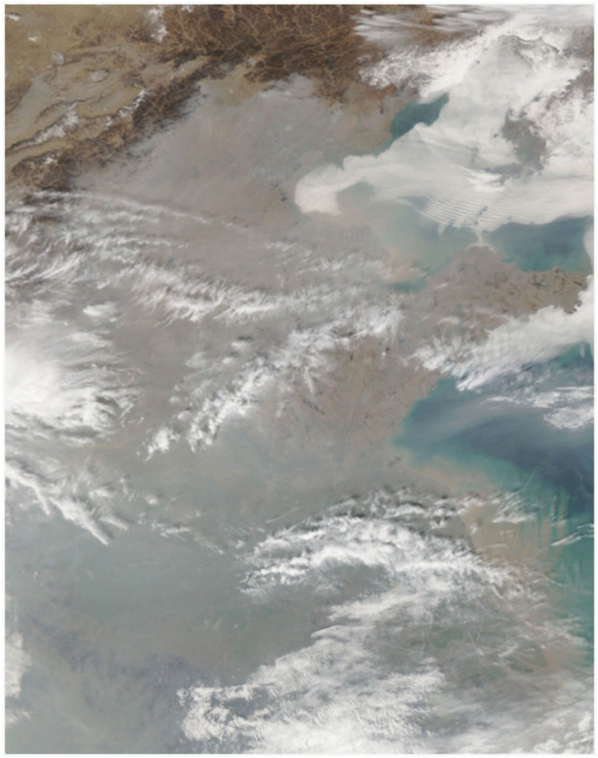


Figure 11.1.3: Smog over Beijing, 2006. Source: NASA's Earth Observatory, "Thick Smog of Beijing, China," November 8, 2005, accessed March 14, 2011, earthobservatory .nasa.gov/IOTD/view.php?id=6000.

Although few countries regulated GHGs from vehicles as of 2009, many have focused on reducing other pollutants. The United States, the European Union, India, China, and other countries realized that particulate matter emissions from diesel fuel in particular could not be controlled at the tailpipe or locomotive exhaust vent without changing the whole supply chain, and without that change, about 85 percent of the largest cities in developing countries would continue to suffer poor air quality.United Nations Environment Programme, Partnership for Clean Fuels and Vehicles, "Background," accessed November 30, 2010, www.unep.org/pcfv/about/bkground.asp. Thus US refineries have been mandated to produce diesel fuel at or below fifteen parts sulfur per million. This is being phased in for vehicles, trains, ships, and heavy equipment from 2006 to 2014. The lower sulfur content both reduces the sulfur dioxide formed during combustion and allows the use of catalytic converters and other control technology that would otherwise be rapidly corroded by the sulfur.

For CO2 from these mobile sources, in 2009 President Obama asked the EPA to reconsider California's request to regulate GHG emissions from vehicles, a request initially denied under the Bush administration despite a 2007 Supreme Court ruling that required the EPA to regulate GHGs under the Clean Air Act. Assuming California adopts stricter vehicle emissions standards, almost twenty other states will adopt those standards. Moreover, the American Recovery and Reinvestment Act of 2009 appropriated billions of dollars for green infrastructure, including high-speed rail.

Interactive Timeline of California Petition to Regulate GHGs from Cars

www.americanprogress.org/issues/2009/01/emissions_timeline.html

The Kyoto Protocol itself, nonetheless, faced an uncertain fate under the Obama administration. Discussions for the successor to Kyoto were held in December 2009 in Copenhagen. In the interim between those two frameworks, over 180 nations plus nongovernmental organizations (NGOs)—many criticized for the carbon footprint of traveling in private jets—attended the UN Bali Climate Change Conference in December 2007.

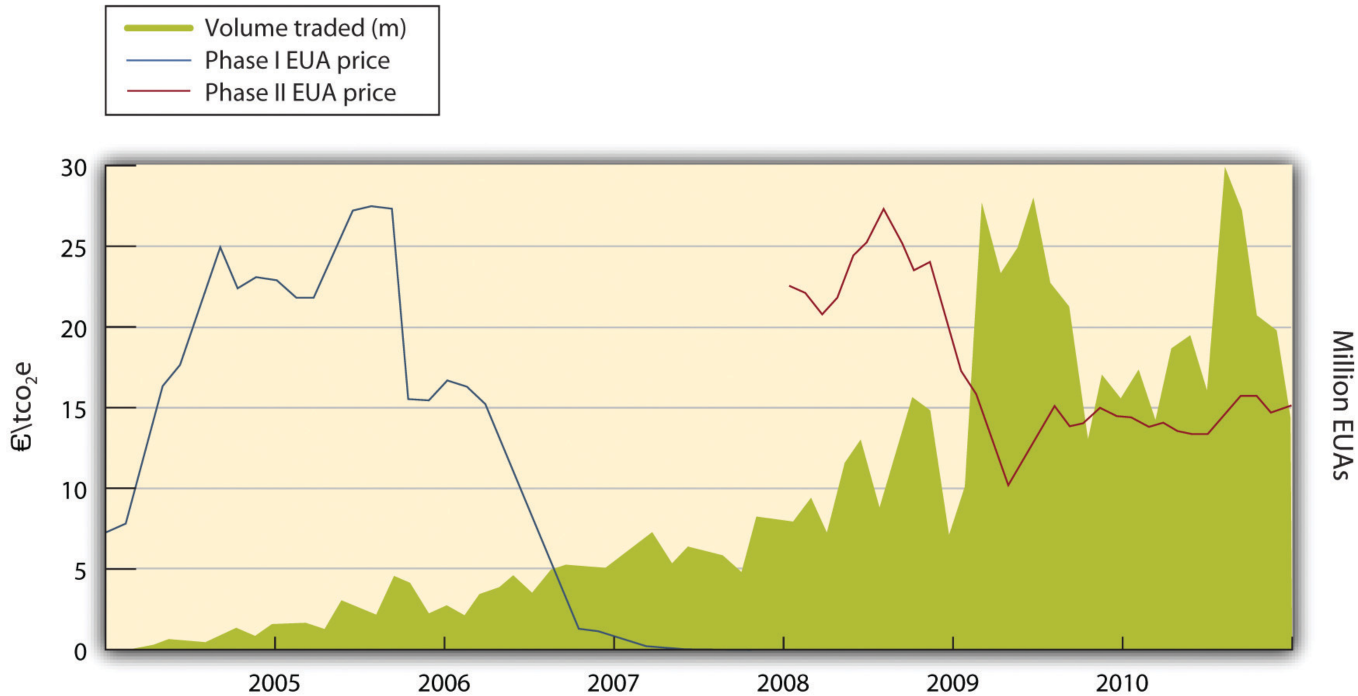
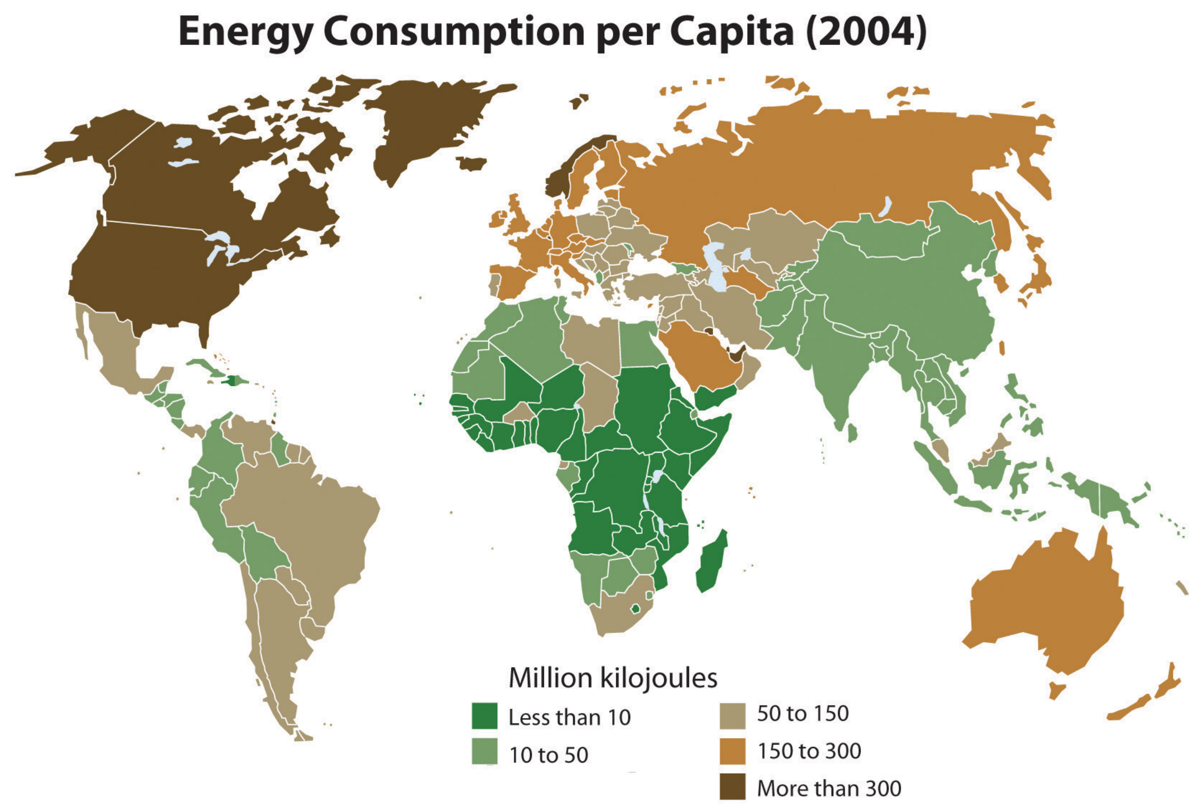
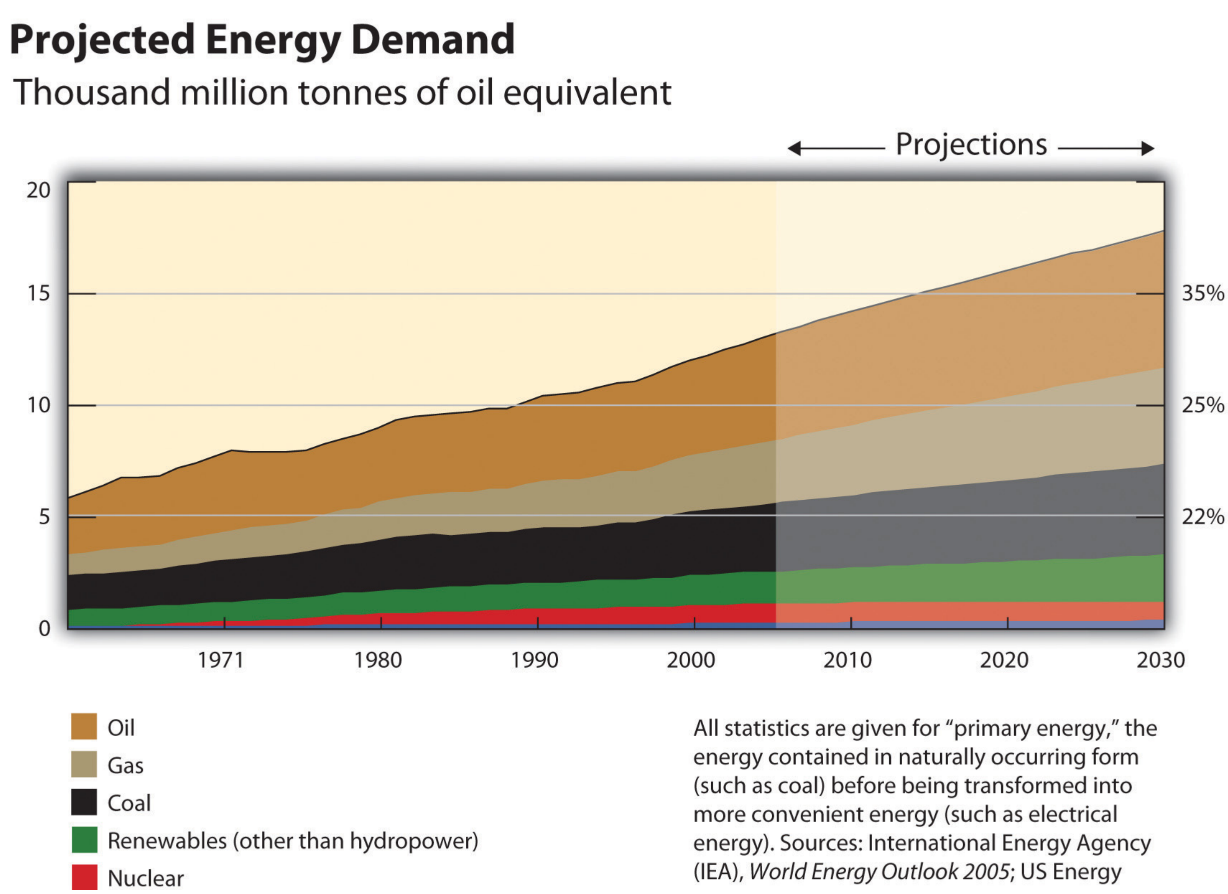


Figure 11.1.4: European Union Emissions Trading System (ETS) Carbon Prices, 2005–7. Source: Committee on Climate Change, Fourth Carbon Budget (2010), 93, accessed March 21, 2011, downloads.theccc.org.uk.s3.amazonaws.com/4th%20Budget/CCC-4th-Budget-Book_with-hypers.pdf

As climate change and its consequences have become increasingly accepted as real, more people and institutions are considering their "carbon footprints," the levels of CO2 associated with a given activity. A number of voluntary programs, such as the Climate Registry, ISO 14000 for Environmental Management, and the Global Reporting Initiative, emerged to allow organizations and businesses to record and publicize their footprint and other environmental performance tracking. To assess and abet such efforts, in 2000 the US Green Building Council introduced a rating system called Leadership in Energy and Environmental Design (LEED). Buildings earn points for energy efficiency, preserving green space, and so on; points then convert to a certification from basic to platinum. The 7 World Trade Center building, for instance, was gold certified upon its reconstruction in 2006.Taryn Holowka, "7 World Trade Center Earns LEED Gold," US Green Building Council, March 27, 2006, accessed March 27, 2009, www.usgbc.org/News/USGBCNewsDetails.aspx?ID=2225. Other green building programs have appeared, while groups such as TerraPass and CarbonFund began selling carbon offsets for people to reduce the impact of their local pollution. Investors also have jumped in. Sustainable-investment funds allow people to buy stocks in companies screened for environmental practices and to press shareholder resolutions. For example, institutional investors representing state retirement funds have asked for evidence that management is fulfilling its fiduciary responsibility to protect the stock price against climate change impacts and other unexpected ecological and related political surprises. The Social Investment Forum's 2007 Report on Socially Responsible Investing Trends in the United States noted that about 11 percent of investments under professional management in the United States—$2.7 trillion—adhered to one or more strategies of "socially responsible investment," a category encompassing governance, ecological, health, and safety concerns.Social Investment Forum, 2007 Report on Socially Responsible Investing Trends in the United States (Washington, DC: Social Investment Forum Foundation, 2007), accessed March 27, 2009, www.socialinvest.org/resources/research.



Energy Consumption per Capita (2004)
Million kilojoules
Less than 10
10 to 50
50 to 150
150 to 300
More than 300



Projected Energy Demand
Thousand million tonnes of oil equivalent
Projections
20
15
10
5
0
35%
25%
22%
1971
1980
1990
2000
2010
2020
2030
Oil
Gas
Coal
Renewables (other than hydropower)
Nuclear
All statistics are given for "primary energy," the energy contained in naturally occurring form (such as coal) before being transformed into more convenient energy (such as electrical energy). Sources: International Energy Agency (IEA), *World Energy Outlook 2005*; US Energy

Figure 11.1.5: Global Per Capita Energy Consumption, 2004. Source: UNEP/GRID-Arendal, "Energy Consumption per Capita (2004)," UNEP/GRID-Arendal Maps and Graphics Library, accessed March 14, 2011, maps.grida.no/go/graphic/energy_consumption_per_capita_2004.

Materials and Chemicals

In conjunction with threats to the globe's ecosystems (a somewhat removed and therefore abstract notion for many), people became increasingly aware of threats to their personal health. This concern shifts attention from climate and energy issues at a more macro level to the material aspects of pollution and resource management.

Knowledge about health threats from chemical exposure goes back in history. Lead and mercury were known human toxins for centuries, with the "mad hatter" syndrome caused by hat makers' exposure to mercury, a neurotoxin. The scale and scope of chemicals' impacts, combined with dramatically improved scientific analysis and monitoring, distinguish today's challenges from those of the past. Bioaccumulation and persistence of chemicals, the interactive effect among chemicals once in the bloodstream, and the associated disruptions of normal development have continued to cause concern through 2010. Chemical off-gassing from materials used to build Federal Emergency Management Agency (FEMA) temporary housing trailers causing health problems for Katrina Hurricane victims, the ongoing health problems of early responders to the 9/11 terrorist attack in New York City, and health issues associated with bisphenol A (BPA) in hard plastic containers and food and beverage cans are some of the well-known issues of public concern raised in the last few years.The US Department of Health and Human Services offers suggestions to parents to avoid exposure to children. See US Department of Health and Human Services, "Bisphenol A (BPA) Information for Parents," accessed November 30, 2010, http://www.hhs.gov/safety/bpa.

The national Centers for Disease Control and Prevention began periodic national health and exposure reports soon after the publication of Our Stolen Future, authored by Theo Colborn, Dianne Dumanoski, and John Peterson Myers.See the home page for the book: "Our Stolen Future," accessed March 7, 2011, www.ourstolenfuture.org Considered by many as the 1990s sequel to Rachel Carson's groundbreaking 1962 book Silent Spring, which informed and mobilized the public about pesticide impacts, Our Stolen Future linked toxins from industrial activity to widespread and growing human health problems including compromises in immune and reproductive system functions. In 2005, the federal government's Third National Report on Human Exposure to Environmental Chemicals found American adults' bodies contained noticeable levels of over one hundred toxins (our so-called body burden), including the neurotoxin mercury taken up in our bodies through eating fish and absorbing air particulates (from fossil fuel combustion) and phthalates (synthetic materials used in production of personal care products, pharmaceuticals, plastics, and coatings such as varnishes and lacquers). Phthalates are associated with cancer outcomes and fetal development modifications.

BPA, an endocrine-disrupting chemical that can influence human development even at very low levels of exposure, has been associated with abnormal genital development in males, neurobehavioral problems such as attention deficit/hyperactivity disorder (ADHD), type 2 diabetes, and hormonally mediated cancers such as prostate and breast cancers.Frederick S. vom Saal, Benson T. Akingbemi, Scott M. Belcher, Linda S. Birnbaum, D. Andrew Crain, Marcus Eriksen, Francesca Farabollini, et al., "Chapel Hill Bisphenol A Expert Panel Consensus Statement: Integration of Mechanisms, Effects in Animals and Potential to Impact Human Health at Current Levels of Exposure," Reproductive Toxicology 24, no. 2 (August/September 2007): 131–38, accessed November 30, 2010, www.ewg.org/files/BPAConsensus.pdf.

A recent update found three-fourths of Americans had triclosan in their urine, with wealthier Americans having higher levels.The report and updates are available from Centers for Disease Control and Prevention (CDC). See Centers for Disease Control and Prevention, "National Report on Human Exposure to Environmental Chemicals," last modified October 12, 2010, accessed November 30, 2010, http://www.cdc.gov/exposurereport. This antibiotic is added to soaps, deodorants, toothpastes, and other products. In the first decade of the twenty-first century, pharmaceutical companies were coming under greater scrutiny as antibiotics and birth control hormones were found in city water supplies; the companies had to begin to assess their role in what has come to be called the PIE (pharmaceuticals in the environment) problem. Children, because of their higher consumption of food and water per body weight and their still-vulnerable and developing neurological, immune, and reproductive systems, are especially at risk.

> **The Prevalence of Contamination**
>
> Virtually all of America’s fresh water is tainted with low concentrations of chemical contaminants, according to the new report of an ambitious nationwide study of streams and groundwater conducted by the U.S. Geological Survey.C. Lock, “Portrait of Pollution: Nation’s Freshwater Gets Checkup,” Science News, May 22, 2004, accessed March 7, 2011, findarticles.com/p/articles/mi_m1200/is_21_165/ai_n6110353.

Europe has led the world in its public policy response to reduce the health risks of chemicals. After many years of debate and discussion with labor, business, and government, the EU adopted the “precautionary principle” in 2007, requiring manufacturers to show chemicals were safe before they could be introduced on a wide scale.European Commission, “What Is REACH?,” last modified May 20, 2010, accessed November 30, 2010, ec.europa.eu/environment/chemicals/reach/reach_intro.htm. The REACH directive—Registration, Evaluation, Authorization, and Restriction of Chemicals—will be phased into full force by 2018. REACH requires manufacturers and importers to collect and submit information on chemicals’ hazards and practices for safe handling. It also requires the most dangerous chemicals to be replaced as safer alternatives are found.

The opposite system, which gathers toxicological information after chemicals have spread, prevails in the United States. Hence only after a spate of contaminated products imported from China sickened children and pets did Congress pass the US Consumer Product Safety Act amendments in 2008 to ban lead and six phthalates from children’s toys. However, another phthalate additive, BPA, was not banned. Often found in #7 plastics, including popular water bottles seen on college campuses around the country, BPA was linked to neurological and prostate problems by the National Toxicology Program.National Institute of Environmental Health Sciences, National Toxicology Program, Bisphenol A (BPA) (Research Triangle Park, NC: National Institutes of Health, US Department of Health and Human Services, 2010), accessed November 30, 2010, www.niehs.nih.gov/health/docs/bpa-factsheet.pdf. Although the US Food and Drug Administration (FDA), unlike its EU and Canadian counterparts, chose not to ban the chemical, many companies stopped selling products with BPA.

> **Environmental Health Information**
>
> Environmental Health News provides environmental health information, global and updated daily.
>
> www.environmentalhealthnews.org.

Indeed, consumers have been increasingly wary of materials that inadvertently enter their bodies through the products they use, the air they breathe, and what they put into their bodies by diet. Sales of organic and local foods have been rising rapidly in numbers and prominence since the 1990s due to a greater focus on health. According to the Organic Trade Association, organic food sales climbed from $1 billion in 1990 to $20 billion in 2007.Organic Trade Association, “Industry Statistics and Projected Growth,” June 2010, accessed November 30, 2010, http://www.ota.com/organic/mt/business.html. Once found only in natural food stores, organic foods have been sold predominantly in conventional supermarkets since 2000.Carolyn Dimitri and Catherine Greene, Recent Growth Patterns in the U.S. Organic Foods Market, Agriculture Information Bulletin No. AIB-777 (Washington, DC: US Department of Agriculture, Economic Research Service, 2002), accessed December 1, 2010, www.ers.usda.gov/publications/aib777/aib777.pdf. Meanwhile, community-supported agriculture by 2007 encompassed nearly 13,000 farms as people grew more interested in sourcing from their local food shed.US Department of Agriculture, “Community Supported Agriculture,” last modified April 28, 2010, accessed November 30, 2010, http://www.nal.usda.gov/afsic/pubs/csa/csa.shtml. In addition to protection against food supply disruption due to fuel price volatility, terrorist attack, or severe weather (most foods are transported over 1,000 miles to their ultimate point of consumption, creating what many view as undesirable distribution system vulnerabilities), local food production ensures traceability (important for health protection), higher nutritional content, fewer or no chemical preservatives to extend shelf life, and better taste while providing local economic development and job creation.

Whether from energy production or materials processing, a major challenge across the board is where to put the waste. As visible and molecular waste accumulates, there are fewer places to dispose of it. Global carbon sinks, the natural systems (oceans and forests) that can absorb GHGs, show signs of stress. Oceans may have reached their peak absorption as they acidify and municipal waste washes onshore. Forests continue to shrink, unable to absorb additional CO2 emissions still being pumped into the atmosphere. The United Nations’ Food and Agriculture Organization reported that from 1900 to 2005, Africa lost about 3.1 percent of its forests; South America lost around 2.5 percent; and Central America, which had the highest regional rate of deforestation, lost nearly 6.2 percent of its forests. Individual countries have been hit particularly hard: Honduras lost 37 percent of its forests in those 15 years, and Togo lost a full 44 percent. However, the largest absolute loss of forests continues in Brazil, home of the Amazon rain forest. Brazil's forests have been shrinking annually since 1990 by about three million hectares—an area about the size of Connecticut and Massachusetts combined.Food and Agriculture Organization of the United Nations, "Global Forest Resources Assessment 2005," last modified November 10, 2005, accessed March 26, 2009, http://www.fao.org/forestry/32033/en.

Video Clip

World Wildlife Fund Video on Deforestation

(click to see video)

Solid waste, particularly plastics, has also come under increasing scrutiny because of its proliferation in and outside of landfills. Estimates put the number of plastic bags used annually in the early 2000s between five hundred billion and five trillion.John Roach, "Are Plastic Grocery Bags Sacking the Environment?," National Geographic News, September 2, 2003, accessed November 30, 2010, news.nationalgeographic.com/news/2003/09/0902_030902 _plasticbags.html; "The List: Products in Peril," Foreign Policy, April 2, 2007, accessed March 25, 2008, www.foreignpolicy.com/story/cms.php?story_id=3762. These bags, made from oil, are linked to clogged waterways and choked wildlife. Mumbai, India, forbade stores from giving out free plastic bags in 2000. Bangladesh, Ireland, South Africa, Rwanda, and China followed suit with outright bans or fees for the bags."The List: Products in Peril," Foreign Policy, April 2, 2007, accessed March 25, 2008, www.foreignpolicy.com/story/cms.php?story_id=3762; "China Bans Free Plastic Shopping Bags," International Herald Tribune, January 9, 2008, accessed November 30, 2010, www.iht.com/articles/2008/01/09/asia/plastic.php. San Francisco became the first US city to ban plastic bags at large supermarkets and pharmacies in 2007.Charlie Goodyear, "S.F. First City to Ban Plastic Shopping Bags," San Francisco Chronicle, March 28, 2007, accessed March 25, 2009, www.sfgate.com/cgi-bin/article.cgi?file=/c/a/2007/03/28/MNGDROT5QN1.DTL. Los Angeles passed a similar ban in 2008 that takes effect in 2010 unless California adopts rules to charge patrons twenty-five cents per bag. Los Angeles had estimated that its citizens alone consumed about 2.3 billion plastic bags annually and recycled less than 5 percent of them.David Zahniser, "City Council Will Ban Plastic Bags If the State Doesn't Act," Los Angeles Times, July 23, 2008, accessed March 25, 2009, http://articles.latimes.com/2008/jul/23/local/me-plastic23.

The Life Cycle and Impact of Business Activity on Global Scale

www.storyofstuff.com

Bottled water may now face a similar fate because of the tremendous increase in trash from plastic bottles and the resources consumed to create, fill, and ship those bottles.Charles Fishman, "Message in a Bottle," Fast Company, July 1, 2007, accessed March 26, 2009, www.fastcompany.com/magazine/117/features-message- in-a-bottle.html. New York City, following San Francisco; Seattle; Fayetteville, Arkansas; and other cities, has curbed buying bottled water with city money.Jennifer Lee, "City Council Shuns Bottles in Favor of Water from Tap," New York Times, June 17, 2008, accessed March 26, 2009, www.nytimes.com/2008/06/17/nyregion/17water.html. The inability of natural systems to absorb the flow of synthetic waste was dramatically communicated with reports and pictures of the Great Pacific Garbage Patch, also known as the North Pacific Gyre. Pacific Ocean currents create huge eddies where plastic waste is deposited and remains in floating islands of garbage.

Video Clip

Greatgarbagepatch.org

(click to see video)

Although manufacturers of other products from CDs to laundry detergent have already decreased the amount of packaging they use, and although many American municipalities have increased their recycling capacity, the results are far less than what is required to achieve sustainability, and they still lag behind Europe's progress. The European Parliament and Council Directive 94/62/EC of December 1994 set targets for recycling and incinerating packaging to create energy. By 2002, recycling rates in the EU exceeded 55 percent for glass, paper, and metals, although only about 24 percent of plastic was being recycled.Europa, "Packaging and Packaging Waste," accessed March 27, 2009, europa.eu/scadplus/leg/en/lvb/l21207.htm#AMENDINGACT. An EU directive from 2003 addressed electronic waste specifically, requiring manufacturers of electronic equipment to set up a system to recycle their products. Target recycling rates were initially set at 70 percent by weight for small, household electronics and 80 percent for large appliances, with separate rates for recycling or reusing individual components.Europa, "Waste Electrical and Electronic Equipment," last modified January 6, 2010, accessed November 30, 2010, europa.eu/scadplus/leg/en/lvb/l21210.htm.

The United States as of March 2009 had no federal mandate for reclaiming electronic waste (e-waste), although some states had implemented their own rules.US Environmental Protection Agency, "eCycling: Regulations/Standards," last modified February 23, 2010, accessed November 30, 2010, www.epa.gov/epawaste/conserve/materials/ecycling/rules.htm. Companies such as Dell, criticized for their lack of attention to e-waste, responded to NGO and public concern with creative solutions. Working with citizen groups, Dell was able to shift from viewing e-waste as someone else's problem to developing a profit-making internal venture that reused many electronic devices, put disassembled component materials back into secondary markets, and reduced the dumping of e-waste into poor countries.

KEY TAKEAWAYS

- The world is composed of energy and materials, and how we design business activity defines the ways we use energy and materials.
- There is growing concern that current patterns of use for energy and materials are not sustainable. Waste streams are the focus of much of this concern.

EXERCISES

1. Propose an idea for a product that has sustainability concepts designed in from the outset. How does this change your thinking about resources you might use? How might it change processes of decision making within the firm and across supply chains?
2. What key elements characterize the standard model of business? What barriers can you list that would need to be overcome to move a mainstream business to a sustainability view?

11.2: Defining Sustainability Innovation

> **Learning Objectives**
>
> 1. Understand how sustainability innovation has been defined.
> 2. Begin to apply the basic ideas and concepts of sustainability design.

Recognition that the global economy is processing the world's natural resources and generating waste streams at an unprecedented scale and scope calls for the redesign of commercial activity. Reconfiguring how we conduct business and implementing business practices that preserve the world's natural resources for today's communities and the economic, environmental, and social health and vitality of future generations only recently has become a priority. This notion lies at the heart of sustainability. Sustainability in the business sense is not about altruism and doing what is right for its own sake. Businesses with successful sustainability strategies are profitable because they integrate consideration of clean design and resource conservation throughout product life cycles and supply chains in ways that make economic sense. Sustainability innovation is about defining economic development as the creation of private and social wealth to ultimately eliminate harmful impacts on ecological systems, human health, and communities.

Awareness of the problem of pollution and resource limits has existed for decades but until now only in fragmented ways across informed academic and scientific subcommunities. Today it is becoming self-evident that our past patterns of energy and material use must be transformed. While some still question the seriousness of the challenges, governments and companies are responding. Government is imposing more environmental, health, and safety regulatory constraints on business. However, while regulation may be an important part of problem solving, it is not the answer. Fortunately, businesses are stepping up to the challenge. In fact, the inherent inefficiencies and blind spots that are built into the accepted business and growth models that have been debated and discussed for many years are beginning to be addressed by business. Entrepreneurial innovators are creating solutions that move us away from needing regulation. In addition, recently the critiques have moved from periphery to mainstream as it has become increasingly clear to the educated public that the economic practices that brought us to this point are not sufficient to carry us forward. Since governments alone cannot solve the problems, it will take the ingenuity of people across sectors to generate progress. Sustainability innovation offers a frame for thinking about how entrepreneurial individuals and firms can contribute.

The new models of business sustainability are emerging. They are based on current science, pressure from governments, and citizen demand and envision a world in which human economic development can continue to be sustained by natural systems while delivering improved living standards for more people. That is the goal; however, it takes concrete actions striving toward that ideal to make headway. Those entrepreneurs and ventures embodying the ideal of sustainability have found creative ways to achieve financial success by offering products that improve our natural environment and protect and preserve human health, equity, and community vitality. We will now explore this term, sustainability, and its significance in entrepreneurial thinking.

General Definition

Sustainability innovation reflects the next generation of economic development thinking. It couples environmentalism's protection of natural systems with the notion of business innovation while delivering essential goods and services that serve social goals of human health, equity, and environmental justice. It is the wave of innovation pushing society toward clean technology, the green economy, and clean commerce. It is the combined positive, pragmatic, and optimistic efforts of people around the world to refashion economic development into a process that addresses the fundamental challenges of poverty, environmental justice, and resource scarcity. At the organizational level, the term sustainability innovation applies to product/service and process design as well as company strategy.

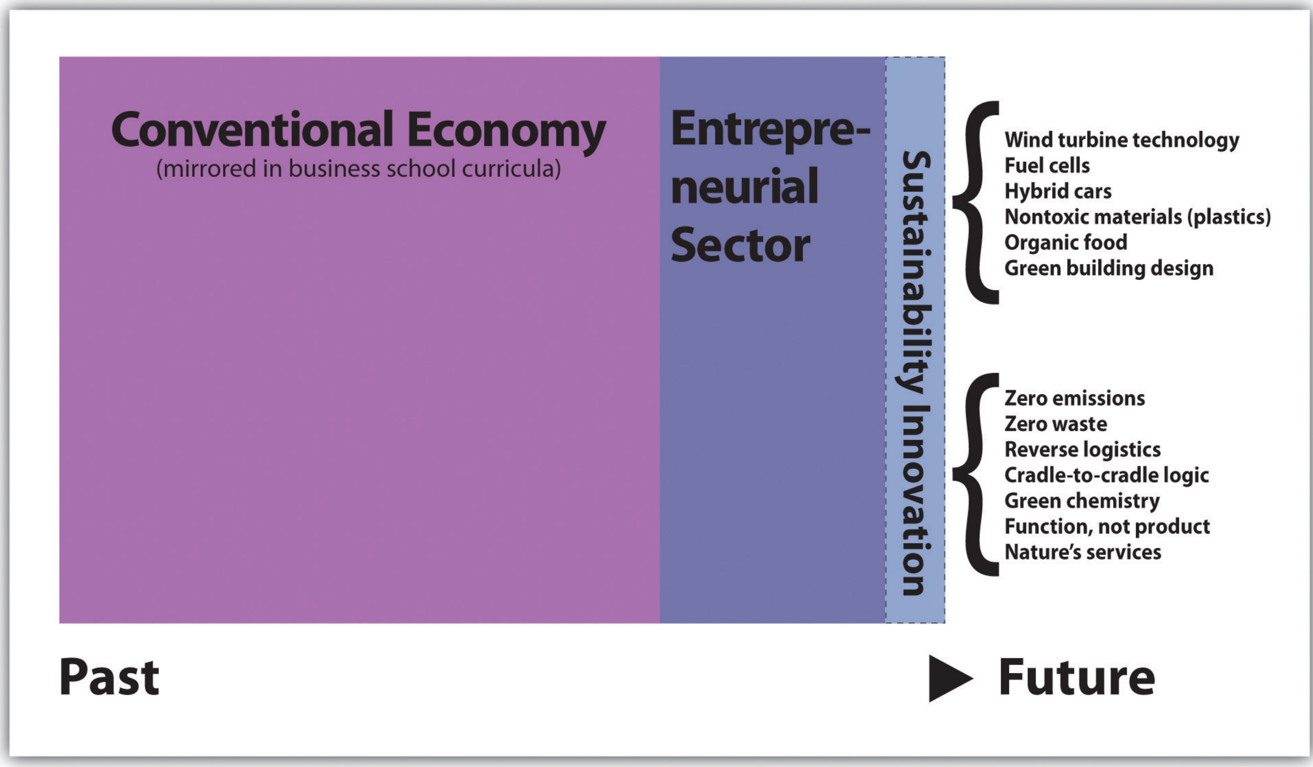


Figure 11.2.1: The Movement toward Sustainability Innovation

Sustainability and sustainability innovation have been defined by different individuals representing diverse disciplines and institutions. Certain fundamentals lie at the concepts' core, however, and we illuminate these fundamentals in the discussion that follows. Keep in mind that any given definition's precision is less important than the vision and framework that guide actions in the direction of enduring healthy economic development. Later we will examine concepts and tools that are used to operationalize sustainability strategy and design. It is by combining existing definitions with an understanding of sustainability's drivers and then studying how entrepreneurial innovators implement the concept that you gain the full appreciation for the change sustainability represents. Note that you will find the terms sustainability, sustainable business, and even sustainability innovation used loosely in the media and sometimes applied to activities that are only continued ("sustained") as opposed to the meaning of sustainability we work with in this text. Our definition addresses the systemic endurance and smooth functioning of ecological systems and the preservation of carrying capacities, together with protection of human health, social justice, and vibrant communities. We are interested in entrepreneurial and innovative disruption that can accelerate progress along this path.

Sustainability: Variations on a Theme

Paul E. Gray, a former president of the Massachusetts Institute of Technology (MIT), stated in 1989 that "furthering technological and economic development in a socially and environmentally responsible manner is not only feasible, it is the great challenge we face as engineers, as engineering institutions, and as a society."Paul E. Gray, "The Paradox of Technological Development," in Technology and Environment (Washington, DC: National Academy Press, 1989), 192–204. This was his expression of what it meant for MIT to pursue sustainability ideas.

Sustainability Defined by Chemical Engineers

A sustainable product or process is one that constrains resource consumption and waste generation to an acceptable level, makes a positive contribution to the satisfaction of human needs, and provides enduring economic value to the business enterprise.Bhavik R. Bakshi and Joseph Fiksel, "The Quest for Sustainability: Challenges for Process Systems. Engineering," AIChE Journal 49, no. 6 (2003): 1350.

Sustainability Defined by The Natural Step

Pediatric cancer physician and researcher Karl-Henrik Robèrt, the founder of an educational foundation called The Natural Step that helps corporations and municipalities implement sustainability strategies, conveys sustainability this way: "Resource utilization should not deplete existing capital, that is, resources should not be used at a rate faster than the rate of replenishment, and waste generation should not exceed the carrying capacity of the surrounding ecosystem."Karl-Heinrik Robert, The Natural Step: A Framework for Achieving Sustainability in Our Organizations (Cambridge, MA: Pegasus, 1997).

The Natural Step, a framework to guide decision making and an educational foundation with global reach based in Stockholm, Sweden, offers a scientific, consensus-based articulation of what it would mean for sustainability to be achieved by society and for humans to prosper and coexist compatibly with natural systems. Natural and man-made materials would not be extracted, distributed, and built up in the world at a rate exceeding the capacity of nature to absorb and regenerate those materials; habitat and ecological systems would be preserved; and actions that create poverty by undermining people's capacity to meet fundamental human needs (for subsistence, protection, identity, or freedom) would not be pursued. These requisite system conditions acknowledge the physical realities of resource overuse and pollution as well as the inherent threat to social and political stability when human needs are systematically denied.

Sustainability Defined in a Business Operations Journal

The search for sustainability can lead to innovation that yields cost savings, new designs, and competitive advantage. Like the quality gurus who called for zero defects, the early adopters of the sustainability perspective may seem extreme in calling for waste-free businesses in which the nonproduct outputs become inputs for other products or services. But sustainability's zero-waste goal offers a critical, underlying insight: health, environmental, and community social issues offer opportunities for businesses.Andrea L. Larson, Elizabeth Olmsted Teisberg, and Richard R. Johnson, "Sustainable Business: Opportunity and Value Creation," Interfaces: International Journal of the Institute for Operations Research and the Management Sciences 30, no. 3 (May/June 2000), 2.

Examining innovative leaders provides a window into the future through which we can see new possibilities for how goods and services can be delivered if sufficient human ingenuity is applied. The approach extends the premises of entrepreneurial innovation, a long-standing driver of social and economic change, to consider natural system viability and community health. Drawing on systems thinking, ecological and environmental health sciences, and the equitable availability of clean commerce economic development opportunities, sustainability innovation offers a fast-growing market space within which entrepreneurial leaders are offering solutions and paths forward to address some of society's most critical challenges.

It is important to recognize sustainability's cross-disciplinary approach. Sustainability in business is about designing strategies for value creation through innovation using an interdisciplinary lens. Specialization and grounding in established disciplines provide requisite know-how, but sustainability innovation requires the ability to bridge disciplines and to rise above the narrow bounds and myopia of specialized training in conventional economic models to envision new possibilities. Sustainability innovation occurs when entrepreneurs and ventures stretch toward a better future to offer distinctly new products, technologies, and ways of conducting business. The empirical evidence suggests that while entrepreneurs who succeed typically bring their uniquely specialized know-how to the table, they also have a systems view that welcomes and mixes diverse perspectives to create change.

Business has traveled a long distance from the adversarial pollution control days of the 1970s in the United States, when systemic ecological problems were first acknowledged. Companies were asked to bear the costs of environmental degradation yet often lacked the ability or know-how to realize any rewards for those investments. Decades ago, the goals were narrow: compliance and cost avoidance. Today the intersecting environmental, health, and social challenges are understood as more complex. Community prosperity requires a far broader view of economic development. It requires a sustainability mind-set. While the challenges are undeniably serious, as our examples will show, the entrepreneurial mind sees wide open opportunities.

A growing number of companies now recognize that improving performance and innovation across the full sustainability agenda—financial, ecological, environmental, and social health and prosperity—can grow revenues, improve profitability, and enhance their brands. Sustainability strategies and innovations also position businesses favorably in markets, as their slower-learning competitors fail to develop internal and supply-chain competencies to compete. We predict that within a relatively short period of time what is now considered sustainability innovation will become mainstream business operation.

World Resources Institute's Corporate Ecosystem Services Review

www.wri.org/project/ecosystem-services-review

> Sidestepping the need for sustainability may prove difficult. Population growth rates and related higher levels of waste guarantee environmental concerns will grow in importance. The government and the public are increasingly concerned with the extent and severity of air, water, and soil contamination and the implications of natural resource consumption and pollution for food production, drinking water availability, and public health. As environmental and social problems increase, public health concerns are likely to drive new approaches to pollution prevention and new regulations encompassing previously unregulated activities. As concerns increase, so will the market power of sustainable business. The opportunities are there for the entrepreneurially minded. Sustainability innovation offers solutions.

The entrepreneurial leaders forging ahead with sustainability innovation understand the value of partnerships with supply-chain vendors and customers, nongovernmental organizations (NGOs), public policy agencies, and academia in pursuing product designs and strategies. Many of their innovations are designed to avoid the need for regulation by steadily reducing adverse ecological and health impacts, with the goal of eliminating negative impacts altogether. Significantly, environmental and associated health, community, and equity issues are integrated into core business strategy and thus into the operations of the firm and its supply chains.

Start-up firms and small to midsized companies have always been major movers of entrepreneurial innovation and will continue to lead in sustainability innovation. However, even large firms can offer innovative examples. Indeed, Stuart Hart in his 2005 book Capitalism at the Crossroads: The Unlimited Business Opportunities in Solving the World's Most Difficult Problems argues that multinational corporations have the capacity and qualities to address the complicated problems of resource constraints, poverty, and growth.Stuart L. Hart, Capitalism at the Crossroads (Upper Saddle River, NJ: Wharton School Publishing, 2005). According to analysts of what is termed "bottom of the pyramid" markets where over two billion people live on one to two dollars a day, developing countries represent both a market for goods and the potential to introduce sustainable practices and products on a massive scale.

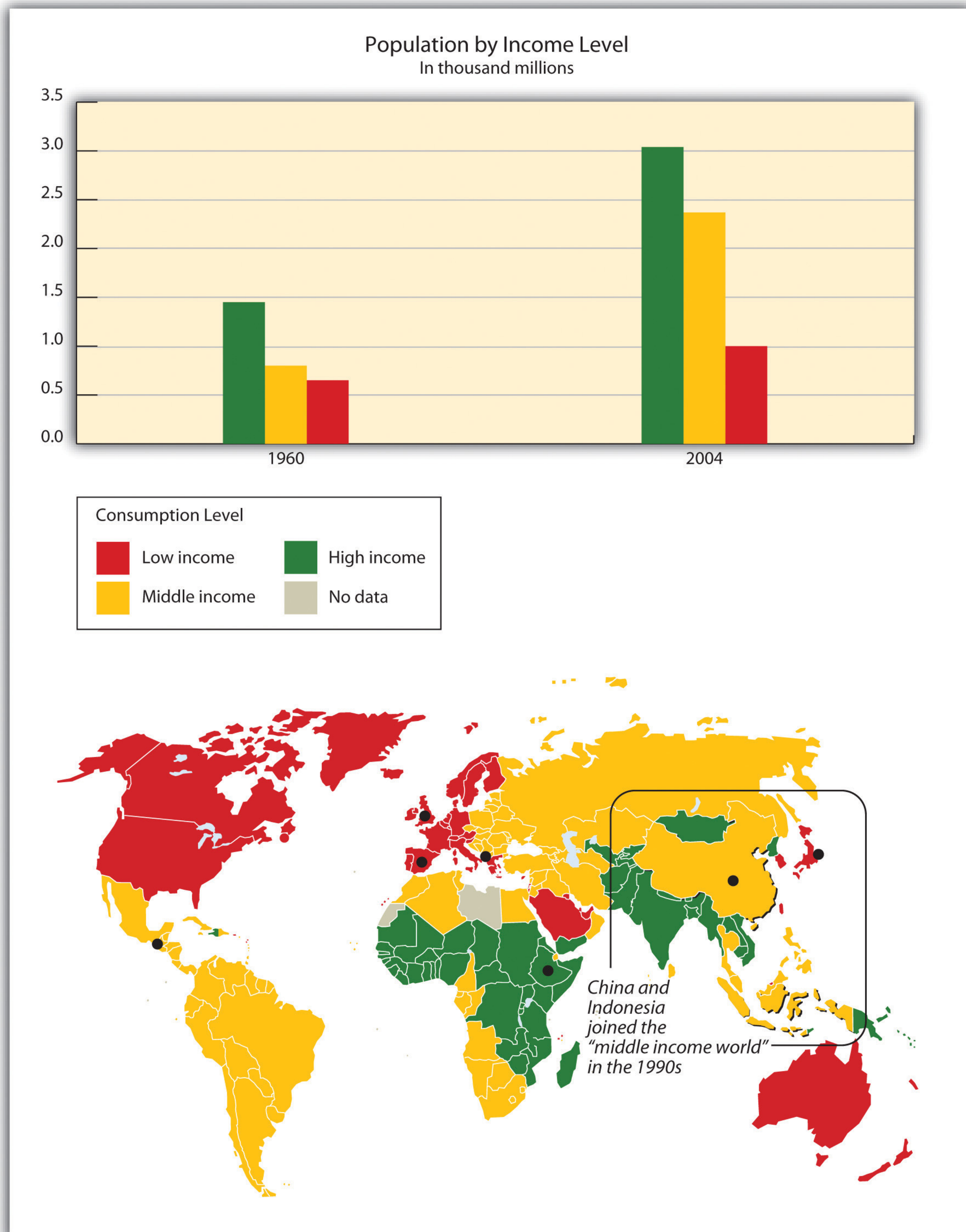


Figure 11.2.2: Growing Wealth but Growing Inequality. Source: UNEP/GRID-Arendal, "Population by Income Level," GRID-Arendal Maps and Graphics Library, accessed March 14, 2011, maps.grida.no/go/graphic/population-by-income-level.

Sustainable Business: Opportunity and Value Creation

- Sustainable business strategies are ones that achieve economic performance through environmentally and socially aware design and operating practices that move us toward a cleaner, healthier, more equitable (and hence more stable) world.
- Sustainable business entrepreneurs understand that sustainability opportunities represent a frontier for creativity, innovation, and the creation of value.

By the first decade of the twenty-first century, a growing number of business executives believed that sustainability should play a role in their work. PricewaterhouseCoopers found that in 2003, 70 percent of CEOs surveyed believed that environmental sustainability was important to overall profit. By 2005, that number had climbed to 87 percent.Karen Krebsbach, “The Green Revolution: Are Banks Sacrificing Profits for Activists’ Principles?” US Banker, December 1, 2005, accessed March 27, 2009, www.accessmylibrary.com/coms2/summary_0286-12108489_ITM. In a later PricewaterhouseCoopers survey of technology executives, 71 percent said they did not believe their company was particularly harmful to the environment, yet 61 percent said it was nonetheless important that they reduce their company’s environmental impact. The majority of executives also believed strong demand existed for “green” and cleaner products and that demand would only increase.PricewaterhouseCoopers, “Going Green: Sustainable Growth Strategies,” Technology Executive Connections 5 (February 2008), accessed March 27, 2009, www.pwc.com/images/techconnect/TEC5.pdf.

Such employers as well as employees have begun striving toward sustainability. Labor unions and environmentalists, once at odds, jointly created the Apollo Alliance to promote the transition to a clean energy environment under the slogan “Clean Energy, Good Jobs.” Van Jones, formerly with the Obama administration, led Green For All, an organization that proposed the new green economy tackle poverty and pollution at the same time through business collaboration in cities to provide clean energy jobs.

Video Clip

Van Jones on Green for All

(click to see video)

Meanwhile, numerous large and well-known companies, including DuPont, 3M, General Electric, Walmart, and FedEx, have taken steps to save money by using less energy and material or to increase market share by producing more environmental products. Walmart, for instance, stated that as of 2009 its “environmental goals are simple and straightforward: to be supplied 100 percent by renewable energy; to create zero waste; and to sell products that sustain our natural resources and the environment.”Walmart, “Sustainability,” accessed March 27, 2009, http://walmartstores.com/Sustainability. But transitioning from a wasteful economic system to one that conserves energy and materials and dramatically reduces hazardous waste, ultimately reversing the ecological degradation and social inequity often associated with economic growth, takes a major shift in the collective state of mind.

Assumptions that Earth systems, regional and local ecological systems, and even the human body can be sustained and can regenerate in the face of negative impacts from energy and material consumption have proven wrong. Linear processes of extracting or synthetically producing raw materials, converting them into products, using those products, and throwing them away to landfills and incinerators increasingly are viewed as antiquated, old-world designs that must be replaced by systems thinking and life-cycle analysis. These new models will explicitly consider poverty alleviation, equity, health, ecological restoration, and smart energy and materials management as integrated considerations. The precise outline of the new approach remains ambiguous, but the direction and trajectory are clear. While government policies may contribute guidelines and requirements for a more sustainable economic infrastructure, the business community is the most powerful driver of rapid innovation and change. The entrepreneurs are leading the way.

In conclusion, economic development trajectories both in the United States and worldwide are now recognized as incompatible with ecological systems’ viability and long-term human health and social stability. Wetlands, coastal zones, are rain forests are deteriorating, while toxins and air and water pollution harm human health and drive political unrest and social instability; witness the growing numbers of environmental refugees. Even large Earth systems, such as the atmosphere and nitrogen and carbon cycles, are endangered. The business models we created in the nineteenth and twentieth centuries that succeeded in delivering prosperity to ever greater numbers of people did not anticipate the exponential population explosion, technological capability to extract and process ever-greater volumes of materials, natural resource demand, growing constraints on resources, political unrest, fuel cost volatility, and limits of ecological systems and human bodies to assimilate industrial waste.

Scholars and students of business will look back on the early decades of the twenty-first century as a transition as the human community responded to scientific feedback from natural systems and took to heart the desire to extend true prosperity to greater numbers by redesigning business. To the extent that this effort will be deemed successful, much of the credit will go to the entrepreneurial efforts to experiment with new ideas and to drive the desired change. No single venture or individual can address the wide range of sustainability concerns. It is the combination of large and small efforts across sectors and industries around the world that will create an alternative future. That is how change happens—and entrepreneurs are at the cutting edge.

KEY TAKEAWAYs

- Sustainability innovation provides new ways to deliver goods and services that are explicitly designed to create a healthier, more equitable, and prosperous global community.
- The sustainability design criteria differ from conventional business approaches by their concurrent and integrated incorporation of economic performance goals, ecological system protection, human health promotion, and community vitality. A new model is emerging through the efforts of entrepreneurial leaders.

Exercises

1. Identify an ecological, equity, health, or product safety problem you see that might be addressed through a sustainability innovation approach. What causes the problem? What kind of shift in mind-set may be required to generate possible solutions?

CHAPTER OVERVIEW

12: Business and the Law

12.1: Contracts

12.2: Documentation and Records

12.3: Contract Components

12.1: Contracts

What you'll learn to do: list and describe the elements of a legally enforceable contract, and explain the consequences of breach of contract

The contract is probably the most familiar legal concept in American society because it's so central to deeply held convictions about the nature of our political, economic, and social life. In this section you'll learn what contracts are and why they're so central to business.

Learning Objectives

- Identify the four elements of a legally enforceable contract
- Explain the legal remedies for breach of contract

What Is a Contract?

A **contract** is a voluntary arrangement between two or more parties that is enforceable as a binding legal agreement.

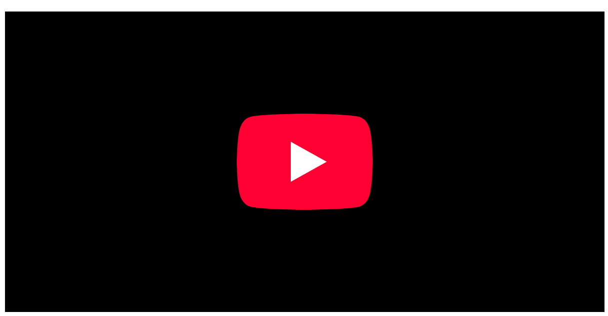
A contract arises when the parties concur that there is an agreement. Formation of a contract generally requires an offer, acceptance, consideration, and a mutual intent to be bound. Each party to a contract must have capacity to enter the agreement. Minors, intoxicated persons, and those under a mental affliction may have insufficient capacity to enter a contract.

A contract may be oral or written, and the lack of a writing does not automatically make the contract void. English law and later U.S. law, however, recognized that oral contracts were subject to fraudulent claims by unscrupulous parties, and so developed the "Statute of Frauds" requiring that certain types of contracts be put into writing in order to be enforceable.

Under U.S. law, a contract must have four essential elements in order to be valid:

1. Offer and Acceptance
2. Consideration
3. Competent Parties
4. Legal Purpose

The following video explains these requirements in greater detail.



Breaches of Contracts

We speak of contracts as being either enforceable (legally binding) or unenforceable. An enforceable contract creates legal obligations, and the failure to comply with them creates a breach of contract.

When a party fails to live up to its obligations under the contract, he is said to have breached the agreement or to be in **breach of contract**. In the case of a breach of contract, the party that has suffered as a result of the breach may be granted one or more of the following remedies:

1. **Specific Performance**. In some circumstances a court will order a party to perform his or her promise under the contract. In this case, the court will make an order of what is called “specific performance,” requiring that the contract be performed. There may be circumstances in which it would be unjust to permit the defaulting party simply to buy out the injured party with damages—for example, if an art collector purchased a rare painting and the vendor refused to deliver, the collector’s damages would be equal to the sum paid, but that wouldn’t exactly be just, since the contracted stipulated receipt of the painting.
2. **Damages**. Damages may be general or consequential. **General damages** are those damages that naturally flow from a breach of contract. **Consequential damages** are those damages that, although not naturally flowing from a breach, are naturally supposed by both parties at the time of contract formation. An example would be when someone rents a car to get to a business meeting, but when that person arrives to pick up the car, it isn’t there. General damages would be the cost of renting a different car. Consequential damages would be the business lost if that person were unable to get to the meeting, if both parties knew the reason the party was renting the car. However, there is still a duty to mitigate the losses. The fact that the car wasn’t there doesn’t give the party a right not to attempt to rent another car.
3. **Discharge of Duties.** There are some instances when, after the breach, both parties are relieved of their obligations under the contract. Let’s say you enter into a contract to purchase a house, but the house is destroyed by a tornado before you can complete the purchase. In this case, the court may decide that since the house is no longer there, the best remedy is to discharge the contract and relieve both parties of their obligation to perform under the contract.

Since almost every exchange in business creates some form of contract, it is essential that business owners as well as consumers understand the fundamental principles of contracts and contract laws.

12.2: Documentation and Records

Key Words and Concepts

- The “put-it-in-writing” rule
- Definition of documentation
- The value of good documentation
- Hearsay
- Job records exception to hearsay rule
- Conditions for introduction of job records
- Letters of transmittal/submittal
- Letters of dispute or protest
- Confirmations and meeting minutes
- Routine job records
- Contractual notices, orders, or directives
- Personal diaries
- Job document matrix

Previous chapters have been replete with references to the importance of well-kept job records in preserving the contractual rights of all parties to the construction process. Another name for well-kept job records is “good documentation,” the subject of this chapter.

Documentation

Good documentation on a construction project does not just happen. It is the result of careful preplanning and a concerted effort at all levels of the field organization. It also requires constant application of the “put-it-in-writing” rule.

“Put-It-in-Writing” Rule

The **“put-it-in-writing” rule** is one of the cardinal rules of good contract administration, if not *the* cardinal rule. It is much easier to state than to implement. Self-discipline and strong work habits are required to detail in writing the thousands of daily occurrences on an active construction job, even though you may know that the potential value of such writings far outweighs the effort required to produce them.

Events should be recorded at or shortly after they occur, not at some later time. Anyone with construction experience knows how intense daily activity can become and how difficult it is to take the time to make a written record of something that has just occurred. Often, this is just not possible at the moment, but it ordinarily can be done at the end of the day or at least by the end of the following day. Even records prepared within a week of the event are more valuable than no records at all. One useful technique is to dictate into a hand-held recorder kept constantly nearby, replacing the tape at the start of each new day. The information from the previous day’s tape can be transcribed by an office associate or stenographer into a daily job diary, a permanent written record. Once transcribed, the tape can be reused on the third day. Such daily records are detailed and extremely valuable for later reference. Writings prepared later than a week or more after the event have little or no value as a job record. By this time, they are more “recollections” than records.

The writer vividly recalls the usefulness of this type of record keeping on a tunnel project executed by his company in the mid-1970s. The project consisted of two parallel soft-ground, shield-driven tunnels under compressed air for a subway project in Baltimore. The schedule required two headings to be driven simultaneously, three shifts per day, five days per week. Each of the three shifts was supervised by a “walker”—a tunnel superintendent—who reported to the general tunnel superintendent. The general tunnel superintendent’s home was in southeastern Washington, D.C., a 75-minute drive from the jobsite. His practice was to arrive at the job early in the morning prior to the end of the graveyard shift so that he could visit each heading during that shift and talk to the graveyard walker. He remained on the job throughout the day shift and stayed long enough into the swing shift to observe conditions in both headings and to talk to the swing shift walker. For this reason, the general tunnel superintendent was intimately familiar with the details of the work in each of the two headings for each of the three shifts of the day. He then dictated the events of the day into a hand-held recorder while waiting in traffic between Baltimore and Washington on his trip home, completing the dictation on the reverse trip from Washington to Baltimore early the next morning. On reaching the jobsite, the cassette for the previous day’s activities was given to the project secretary in exchange for a clean cassette. The secretary typed the dictation each day and returned the copy to the general tunnel superintendent who edited the typed record, making any necessary corrections.

A major differing site condition was encountered during the project, which resulted in a claim for additional compensation and contract time that was litigated before the Maryland Board of Contract Appeals. During the three-week hearing, both the Transit Authority and the contractor almost totally relied on the contractor's job records, including the daily reports resulting from the general tunnel superintendent's dictation. Although the language in these reports was sometimes quite colorful, the reports proved invaluable in securing a successful board ruling.

What Is Documentation?

Written work products that are mere recitations or summaries written long after events occur are often incorrectly represented as documentation. Such written work products may be useful as effective tools of persuasion in a dispute resolution proceeding, but they are *not* documentation. Contemporaneous written records of the facts themselves *are* documentation, but the recitations and summaries are not.

Written opinions of persons who were not present at the events in question also do not constitute documentation, no matter how experienced and knowledgeable the persons may be. Such expert opinions are important and useful in successfully resolving disputes and may be heavily relied upon by courts and arbitrators, but they are not documentation.

Documentation consists of the writings or records of persons who were present at events, written at the time or shortly after the time of the event. In many instances, it may be the only evidence in existence that reveals what actually occurred.

Value of Good Documentation

Good documentation is invaluable in resolving misunderstandings before they escalate into disputes. One party to a misunderstanding may have an incomplete or incorrect picture of the facts of an event or occurrence on the project. Good documentation of the true facts in the possession of the other party is very effective in clearing up the misunderstanding, thus avoiding a potential dispute before it starts.

If a dispute does arise that cannot be resolved short of litigation or arbitration, the party that can produce carefully prepared authentic job records supporting its position usually will prevail. The litigation or arbitration usually occurs sometime after the completion of the project involved. The actual participants in events, such as the engineers, foremen, and superintendents who were assigned to the project are often not available to testify because they have been transferred to other work, have left the employ of a party to the contract, or even, in some instances, have died. The existing job records, properly prepared by these persons, usually may be introduced and accepted as valid evidence of what actually occurred on the project without the necessity of the person who created the records appearing in court and personally testifying.

The home office principals of the parties involved, such as owners and company officers, usually are more readily available to testify, and they may be knowledgeable about what occurred on the job because their subordinates orally reported events to them at the time. However, they are not permitted to testify about what occurred or did not occur on the job because they were not there; and oral statements made to them by their subordinates are **hearsay** . Hearsay is a communication that is secondhand. The person "knows" some fact only because someone else told it to them, not because the person was present at events and knows the fact to be true on the basis of firsthand knowledge. Since these persons are not allowed to testify, the presentation in court of good documentation of events may be the only way to prove what actually occurred.

Exceptions to the Hearsay Rule

Although hearsay generally may not be admitted as evidence in court, there are certain exceptions. One such exception important to the construction industry is that, subject to certain rules, **construction job records (which are hearsay in written form) are usually permitted to be introduced and accepted as evidence**. The federal rules for acceptance of job records as evidence are quite broad, with the result that the records will be admitted if they can be authenticated as genuine. Some state jurisdictions are more restrictive, but properly authenticated job records will generally be admitted.

Conditions for Introduction of Job Records

In most cases, satisfaction of the following **conditions permit the introduction of job records** as evidence in court:

- It must be established that the persons who prepared or originated the records were actually present at the events covered and were in a position to have accurate knowledge. For instance, no one could reasonably argue that a crew foreman's signed and dated time card was not prepared by a person who was present on the job and who had accurate knowledge.

- The records must have been prepared in the normal course of business—that is, it must be shown that the records are of a type that would normally be prepared under the circumstances existing at the time of preparation. For instance, foreman's time cards, project daily progress reports, and accident reports are all clearly the type of documents routinely prepared in the normal course of the business of construction companies. Other examples are daily diaries, weekly and monthly cost reports, force account records, tax returns, material delivery tickets, records of work quantities measured for payment, and so on.
- The records must have been prepared at the time of events, or reasonably soon thereafter.
- There must be no suggestion or intimation that the records were prepared for the specific purpose of use in litigation. Such a suggestion impugns the objectivity and believability of the records.

Typical Job Records

By way of example, the following is a discussion of 20 typical construction job record documents. Each document is intended to serve specific purposes. To be certain that these purposes are served, each must be carefully drafted and must contain certain necessary elements. The specific job records are:

1. Letters of transmittal
2. Letters of submittal
3. Notice of claim for constructive change
4. Notice of claim for constructive suspension
5. Notice of claimed delay
6. Request for time extension
7. Notice of acceleration
8. Notice of differing site conditions
9. Letter requesting information/interpretations
10. Letter disputing instructions/interpretations
11. Letter advising proceeding under protest
12. Confirmations of instructions or agreements
13. Minutes of meetings
14. Project daily reports
15. Force account time and materials records
16. Cross-sections and other records of work performed
17. Foremen's daily time cards
18. Material delivery tickets
19. Contractual notices—that is, NTPs, notice to correct deficiencies, notices of suspension, termination, and so on
20. Personal diaries

For discussion purposes, it is useful to consider these types of documents in a series of six closely related groups.

Letters of Transmittal and Submittal

The first group consists of **letters of transmittal and letters of submittal** (documents 1 and 2). Both are similar in that each is a cover document for some other document of importance, such as a contract, purchase order, subcontract, drawings, schedules, and the like. Each of these documents has two aims: to establish a record of precisely what was transmitted or submitted and a record of the date that the transmittal or submittal was made. It is not difficult to understand the importance of both of these pieces of information with regard to the liability question if, for example, a series of concrete footings, poured according to superseded construction drawings, had to be demolished and repoured. Were the footings wrongly poured because the owner's engineer failed to transmit the revised drawings to the contractor? Or was it because of poor drawing control by the contractor, who left the revised drawings rolled up in the corner of the job trailer and poured the footings according to the original drawings? The letter of transmittal of the revised drawings, if properly drafted, will settle this question.

Letters of submittal differ from letters of transmittal in one important way. Letters of transmittal do not imply or state that an approval is required or sought, whereas letters of submittal do indicate a request for approval. Both usually require an acknowledgement of receipt. Letters of transmittal are typically used to send drawings, specifications, prime contracts, purchase orders, subcontracts, change orders, certificates of insurance and similar documents, whereas letters of submittal are used to send material samples, shop drawings, proposed CPM schedules, proposed methods or procedures for carrying out the work, and the like. Preprinted forms for both letters of transmittal and letters of submittal are in common use today.

Letters of Notice

The second group consists of the typical contractor notices required by the “red flag” clauses of most construction contracts. All of these (documents 3 through 8) contain the same two basic elements as the first group—that is, they describe or identify an event or subject to which the notice pertains, and they establish a date of record that the notice was given. In addition, in each case, the contractor is taking a position. Therefore, each document should contain an additional element, stating the contractor’s position and the basis for believing that the position is correct. In addition to the three preceding elements, the notices in this group should contain other elements, depending on the specific notice. For instance, the notice of acceleration (document 7) should make clear that the contractor is accelerating construction operations and expects to be paid the extra costs of the acceleration. Similarly, the claim for constructive change (document 3), the claim for constructive suspension (document 4), the claimed delay (document 5), an independent request for a time extension (document 6), and the notice of differing site conditions (document 8) should all make the contractor’s position clear and that additional time and money are being requested.

Letters Requesting or Disputing Instructions or Letters of Protest

The third group consists of a **letter requesting information or instructions** (document 9), a **letter disputing or taking exception to instructions previously furnished by owner or engineer** (document 10), and a **letter advising that the contractor is proceeding under protest** (document 11). The two elements of identification and establishment of a date of record are required as for all the other documents. In addition, document 10, which disputes instructions or interpretations, should explain that a dispute exists and the reason that the instructions or interpretations have been disputed. The letter advising proceeding under protest (document 11) must make clear that a dispute exists, that the contractor is proceeding under protest, and that additional time and money are expected.

Confirmations and Meeting Minutes

The fourth group includes **confirmation of instructions or agreements** (document 12) and **minutes of meetings** (document 13). Both possess the two elements of identification and establishment of a date of record and, in addition, contain an element that confirms an understanding of a conversation, meeting, or instructions received. Such letters can relieve the recipient from the necessity of replying by indicating that if no advice to the contrary is received, the understandings stated in the letter or meeting minutes will be regarded as correct.

Routine Job Records

The fifth group—daily reports (document 14), force account records (document 15), cross-section data and other measurements of work performed (document 16), daily time cards (17), and material delivery tickets (18)—all share a common attribute. They are all forms of **routine job records** required to operate the project. Their purpose is to record facts about what has occurred. There are only two elements: recording facts and establishing the date that the facts were recorded.

Contractual Notices, Orders, or Directives

This class of project documents includes the more formal type of **notice, order, or directive**, required by the contract to be given by the owner or construction manager to the prime contractor, or by the prime contractor to subcontractors. Such things as notice of award of contract or subcontract, notices to proceed, stop orders, cure notices (order to remedy defaults), suspension of work or acceleration directives, and termination notices (document 19) are all included in this category. Although less frequent than other job documents, their importance is obvious. They should be drafted with great care and must contain some mechanism to establish the fact and date of delivery.

Personal Diaries

Many construction executives and managers maintain **personal diaries** (document 20) on a routine basis, entering facts about important meetings or events shortly after they occur when recollection is fresh. Such diaries are highly regarded as probative evidence in construction disputes, provided the entries are factual and not unduly editorialized.

The writer maintained this type of daily diary throughout his contracting career. These diaries repeatedly were effectively used in dispute resolution, including use as trial exhibits in court and in hearings before administrative boards. However, such diaries must be factual, inasmuch as they are subject to discovery during litigation. For this reason, some in the industry do not keep diaries because they regard them to be a two-edged sword. However, the writer’s experience has been that the benefits to be gained in maintaining a detailed diary far outweigh the drawbacks. On one occasion, the writer’s original diaries were subpoenaed by the federal government as evidence in a criminal trial involving other parties and were not returned for a number of years. These experiences should make clear the importance that courts, arbitrators, and other dispute resolution bodies place on this type of record.

Job Document Matrix

The relation of the various necessary elements just discussed to the documents themselves is represented diagrammatically by the **job document matrix** shown in Figure 21-1.

[table id=5 /]

Conclusion

Most construction documentation, particularly correspondence, is generated during the "heat of battle" on active construction projects. There are usually two sides to every issue, and each person's view of the situation will be highly influenced by "where he or she sits in the stadium." The purpose in writing a letter to an opposite number should not be to vent one's spleen, but by being factual and professional, to convince the other of the correctness of one's position. Unfortunately, much actual construction correspondence overlooks this simple truth.

Questions and Problems

1. What is the cardinal rule of good contract administration? At what point should the rule be exercised to result in good job documents?
2. Does the term *documentation* include recitations or summaries of events written after the fact? Are later written opinions of qualified construction experts considered to be documentation?
3. Why are good job records useful in construction litigation?
4. Why are home office principals often not permitted to testify in court about events that occurred on the project?
5. What is *hearsay*? Does the hearsay rule usually apply to construction project records?
6. What are the four requirements that must be met before project records may be presented as evidence in court?
7. What is the difference between a letter of transmittal and a letter of submittal?
8. What ten separate elements of various project documents are discussed in this chapter?
9. What is the general purpose of construction correspondence dealing with disputed matters that is so often overlooked in practice?

12.3: Contract Components

Learning Objectives

- Owner-contractor contracts
- Fixed-price, competitively bid contracts
- Standard forms-of-contract
- Federal government construction contract
- AIA contracts
- EJCDC contract
- State highway department contracts
- Other agency contracts
- One-of-a-kind contracts
- Bidding documents
- General conditions
- Supplementary conditions
- Specifications
- Drawings or plans
- Reports of investigations of physical conditions

Continuing the overview of construction-related prime contracts presented in Chapter 3, this chapter focuses on the *particular* construction-related prime contract of interest to construction contractors—that is, **owner–contractor contracts** for construction services. This focus will be concentrated even further by confining the discussion to **fixed-price contracts arrived at by competitive bidding.**

Generally, someone who is knowledgeable and comfortable operating in the competitively bid, fixed-price contract environment usually finds little difficulty when operating under other forms of construction contracts. The reverse is not always true.

Standard Forms of Contract

A number of **standard forms-of-contract** for fixed-price, competitively bid prime construction contracts are widely used today. A discussion of the more prominent of these follows.

Federal Government Construction Contract

Foremost among standard forms-of-contract is the **federal government construction contract**. This form of contract is normally used by all branches of the federal government for construction work. Prominent examples of different federal agencies using this contract include the General Services Administration, the Bureau of Reclamation, the U.S. Army Corps of Engineers, the U.S. Navy Facilities Engineering Command, the U.S. Bureau of Public Roads, and the National Park Service. The actual contracts, depending on the particular federal agency, all differ slightly in the wording of the basic provisions, and the titles used for the contract document divisions vary. However, the contracts are of the same type and contain the same basic provisions.

A typical instance where this form-of-contract was used is the U.S. Army Corps of Engineers Lock and Dam No. 26 project on the Mississippi River. This immense public works project. north of St. Louis, Missouri, involved a series of major contracts beginning in the early 1980s. Bids were taken for the third contract of the series on August 23, 1985, three to four months after it was advertised, so that bidding contractors would have time to prepare their fixed-price bids. The bidding documents consisted of two four-inch-thick volumes of technical specifications, four two-inch-thick volumes of drawings, and seven or eight extensive addendums, each of which made numerous changes in all of the other documents, including previously issued addendums. Obviously, preparing a fixed-price bid for this contract was a complicated matter requiring hundreds of hours. Smaller projects entail fewer documents and require less effort to prepare a bid. But regardless of the size of the federal project, the essential contract provisions under which the project is to be built will be the same. The larger, fixed-price federal contracts that contain a schedule of bid items are the most complex and offer the best example of the variety of problems that can occur. Five bids were received for this Lock and Dam No. 26 contract, ranging from a low bid of $227 million to a high of $288 million.

American Institute of Architects Contracts

A second important standard form-of-contract is the **American Institute of Architects (AIA) Standard Form of Agreement Between Owner and Contractor**. The two companion documents necessary to form the complete contract are AIA Form A-101 and AIA Form A-201. This contract is by far the most widely used form for fixed-price building construction work in both the public and private sectors, particularly the private sector. Entire texts have been written by legal scholars on this particular contract. [1]

Associated General Contractors Contracts

The *AGC Standard Form Prime Contract Between Owner and Contractor* is recommended for use by the Associated General Contractors of America (AGC). This contract is commonly used on private work and is suitable for both building construction and engineered construction projects. Its usage is less broad than that of the AIA contract.

Engineers Joint Contract Documents Committee Contract

Another form-of-contract, the **Engineers Joint Contract Document Committee (EJCDC) Contract**, is used primarily for engineered construction in the private sector. Its use has also been endorsed by the Associated General Contractors of America.

State Highway Department Contracts

Another broad class of competitively bid, fixed-price contracts consists of the **state highway department contracts** of the various states. These contracts tend to be similar in format, no doubt because the construction work within each state is similar. The influence of the Federal Highway Administration (FHWA) has forced this similarity. The format usually consists of an infrequently published "bible," which contains all general provisions and standard technical specifications of the state. Often a revision manual will be periodically published with changes. Then, in addition to the "bible" and its revision manual, each particular project will have its own set of "special provisions" that apply to that particular project. The special provisions contain site-specific provisions and information and any further changes to the "bible" as it relates to that specific project. The technical requirements of these state highway department contracts tend to be similar, even though some general provisions may vary. These contracts, like most others, are written by the owner agencies. From the standpoint of the legal rights afforded the contractor, these contracts vary considerably. Contractors who bid frequently in a particular state are aware of the provisions of that state's contract and know what to expect.

Other Agency Contracts

Many **other agencies** traditionally build infrastructure systems over time through a series of recurring contracts for similar construction work. Examples are the rapid transit districts and water and sewer districts of the large metropolitan centers, as well as state agencies (other than highway departments), such as the California Department of Water Resources and the California Department of Architecture. Each agency tends to create its own unique form of prime construction contract, often based on the federal government contract, which it then uses over and over. Construction contractors who frequently bid to one or more of these agencies become familiar with the terms of the particular form that each agency uses.

One-of-a-Kind Contracts

Occasionally, contracts are created for a particular project. These **one-of-a kind contracts** tend to vary widely. Little about them is standard or traditional, either in format or detailed provisions. Since contracting parties can agree to anything that is not contrary to law, these isolated, individual, one-of-a-kind contracts can take almost any hybrid form that the parties concoct. They are limited only by the imagination of the parties who draft them, each of whom attempts to secure the most favorable agreement possible from that party's point of view. Disputes that arise from one-of-a-kind contracts are usually more difficult to resolve because there is no past pattern of experience, as is the case with one of the "tried-and-true" standard forms-of-contract.

Typical Documents Comprising the Contract

Fixed-price, competitively bid contracts are comprised of certain, fairly typical documents. With the exception of one-of-a-kind contracts, the major categories of most contracts of this type consist of the following list:

- Bidding documents, consisting of the "Invitation to Bid," the "Instructions to Bidders," and the "Bid Form"
- General Conditions of Contract
- Supplementary Conditions of Contract
- Specifications
- Drawings
- Reports of investigations of physical conditions

Some contracts may not contain all of these categories but, with the exception of one-of-a-kind contracts, none is likely to contain material that won't logically fit into one category or another.

Bidding Documents

The first category, **bidding documents**, normally begins with an *advertisement*, originally discussed in Chapter 1. The back section of contemporary industry periodicals, such as the *Engineering News Record*, contains a plethora of bid advertisements with every new issue. The advertisement identifies the project for which bids are desired, the owner, the time and place of the bid opening, and instructions to potential bidders on how to obtain a full set of contract documents.

The second document in the bidding group is usually the *Invitation for Bids (IFB)* or, sometimes, a *Request for Proposals (RFP)*. The federal government and some other owners use the IFB when bidders must strictly conform to the drawings and specifications and the RFP when bidders may propose variations for the project. Both typically include the following:

- A description of the contract work
- The identity of the owner
- The place, date, and precise time of the bid opening
- The penal sum of the required bonds (bid bond, performance bond, and labor and material payment bond)[2]
- A description of the drawings and specifications, their cost, and where they may be obtained
- The length of time after bid opening that bids will be deemed good (duration of bids)
- Rules regarding the withdrawal or modification of bids and late bids
- Information regarding any planned pre-bid conferences and pre-bid site inspections
- Particular requirements of law of which the owner wants bidders to be aware
- Any special instructions, other requirements, or other information that the owner wants to point out to bidders

In addition to the IFB or RFP, the contract documents may also contain a section called *Instructions to Bidders*. When used, this section is an adjunct to the instruction portion of the IFB or RFP. Sometimes all necessary instructions are contained within the IFB or RFP, and there is no separate Instructions to Bidders section. More logically, the Instructions to Bidders is a separate document, and the IFB or RFP contains all of the other necessary but noninstructional information that a bidder needs.

In every case, the contract documents contain the *Bid Form*. Bidders complete this document, sign, seal, and turn it in at the appointed place, prior to the deadline set for the submittal of bids. The fully executed Bid Form constitutes the “offer” element necessary for contract formation, discussed in Chapter 2. Note that the Bid Form must be completely filled out, signed, and sealed, all in accordance with the IFB or RFP and the Instructions to Bidders to constitute a responsive bid. The contents of the Bid Form usually include the following:

- *A definitive statement of the general terms and conditions of the offer.* This statement is normally unilaterally determined by the owner and is preprinted on the form.
- *The format of the commercial terms applying to the offer.* Again, this format is normally determined unilaterally by the owner either as a single lump sum total price or as a schedule of bid-item prices. In the first case, the bid form contains a single blank space in which the bidder is instructed to enter a single lump sum price for the entire project. In the second case, the form contains a numbered series of all bid items for the project, each consisting of a description of the work for discrete parts of the project and either blanks for unit prices and extensions against a preprinted quantity of work or a single blank for a lump sum price. The total bid in this case is the sum of the unit price extensions and lump sum prices. With either a single lump sum format or a schedule-of-bid-items format, the bidder fills in the blanks for defining the precise commercial terms of the bid.
- *Supplementary information that the owner may want to know about the bidder.* This usually consists of information about the bidder’s financial strength and past experience.
- *Additional information for federal bids.* The bid form for federal contracts contains a number of “Certifications and Representations” in affidavit form, such as noncollusion and nonsegregated facilities affidavits, required to comply with federal law.
- *Affirmative action requirements for public projects.* Bid Forms for public projects usually require written goals and timetables for meeting the requirements of equal opportunity legislation and minority business enterprise/women business enterprise requirements.
- *Bid security.* Finally, the Bid Form must contain the required bid security, usually in the form of a bid bond issued by an approved surety. Sometimes, a certified check must be presented for the bid security.

Oddly enough, private sector bids often require much more supplementary information on the Bid Form than do public sector bids. And, among public projects, Bid Forms for federal contracts usually require less supplementary information than the average.

A final interesting point concerning bidding documents is that the AIA approach excludes the bidding documents from the contract. Article 1 of AIA A-201, General Conditions of the Contract for Construction, states:

The Contract Documents do not include Bidding Documents such as the Advertisement or Invitation to Bid, the Instructions to Bidders, sample forms, the Contractor's Bid or portions of Addenda relating to any of these, or any other documents, unless specifically enumerated in the Owner–Contractor Agreement.

Why would the AIA wish to exclude the bidding documents from the contract? The rationale seems to be that the eventual contract is considered to be the end result of a negotiation, not the result of a binding firm-price bid. The bid is regarded as merely the starting point for the ensuing negotiation. Most other forms-of-contract include the bidding documents as part of the contract.

General Conditions of Contract

The second section of the documents that normally comprise the contract is the *General Conditions of Contract*, often referred to simply as the **General Conditions**, or sometimes, **General Provisions**. Here are found very definitive statements, clause by clause, of all general terms and conditions that govern the performance of the contract work. In the case of the federal government and other agencies that frequently contract for construction work, the general concept of this section of the documents is to include all clauses that will remain the same, contract after contract, changing very infrequently. Many of these standard clauses in federal contracts pertain to the requirements of the Federal Acquisition Regulations, which by law must be included in every federal construction contract.

Supplementary Conditions of Contract

In addition to the General Conditions or General Provisions, most construction contracts contain a section called **Supplementary Conditions** or *Special Conditions*. The idea of this section is to include clauses dealing with general matters that apply to the instant contract only—that is, those that are either site-specific or in some other way apply only to the specific contract. Such matters might better be called "project-specific" matters. Some forms of contract do not have a Special (or Supplementary) Conditions section. Instead they include all general matters, whether standard or project-specific, in the General Provisions section. It is also common to include general project-specific matters in Division 1 of the Specifications section. In the Uniform Construction Index (UCI) form of technical specifications, which is widely used, Division 1 is titled "General Requirements." Thus, to be entirely sure that nothing of a general nature has been overlooked in a particular case, it is necessary to carefully read the General Conditions, the Supplementary Conditions (if included), and Division 1 of the Technical Specifications.

One important area of the Supplementary Conditions for contracts where federal funds are involved is the Davis-Bacon Wage Determination originally discussed in Chapter 1. By federal law, wages paid the workers on any such project must be at least as high as listed in the Davis-Bacon Determination for each trade classification involved in the work. Even where federal funds are not required, many states require that prevailing wages be paid on public work. These rates are set by a commissioner on a project-to-project basis at a level he or she has determined through investigation to equal the "prevailing" wage for each classification of work in the locality of the project. This determination is obviously significant to contractors interested in submitting a bid. For example, if the determination is set at low "open-shop" rates, potential bidding contractors, bound by union labor agreements that require payment of higher rates, know that they are competing at a disadvantage and might be well advised not to bid at all. On the other hand, if the Davis-Bacon commissioner has determined the "prevailing" rates to be union labor agreement rates, all bidders are on a more equal footing. Open-shop or merit-shop contractors will have to pay the same rates as union contractors.

Specifications

The technical requirements for each division of work in the contract will be completely detailed in that section of the contract document called the **Specifications**. The format usually conforms to the Uniform Construction Index, which is understood by virtually every segment of the industry. Depending on size of contract, the Specifications can be voluminous. It is necessary that completely definitive requirements be carefully stated so that both parties to the contract have a mutual understanding of the precise technical standards the project work must meet.

Drawings

The next important section of the contract documents is the **Drawings**, which complement the Specifications. The Drawings must be sufficiently complete to adequately show exactly what is to be built. Certain features of the work may be shown in fairly general terms, with the requirement stated that the contractor must prepare detailed shop drawings that conform to and augment the general contract drawings. These must be submitted to the owner or the owner's engineer for approval prior to fabrication of the material covered by the shop drawings. For example, a contractor may supply detailed bar-bending schedules and placing drawings for reinforcing steel and structural steel fabrication and erection drawings, including the connections. However, the basic contract drawings advertised for fixed-price bids must be sufficiently clear and accurate so that, if contractors carefully conform to them, a satisfactorily constructed product will result. If either the Drawings or Specifications do not meet this standard, the owner may incur severe liability under the Spearin Doctrine, which is discussed in Chapter 13.

Reports of Investigations of Physical Conditions

An additional and final section that may or may not be included as an integral part of the contract documents consists of various **reports of investigations of physical conditions** at the project site. These reports often concern geotechnical aspects of subsurface soil or rock conditions. They usually appear in the form of written evaluations and soil boring logs describing subsurface conditions. Other examples are weather records and, in the case of projects on or near streams and rivers, stream flow hydrographs. These reports are probably the more common examples of this type of information, but basically any included information describing physical conditions at the site falls into this category. A more detailed discussion of these kinds of reports and whether or not they are considered to be part of the contract is included in Chapter 5.

Conclusion

This chapter focused on the format and the general contents of the major component sections of prime contracts between owners and general contractors for the performance of construction work. The prominent forms-of-contract commonly used today were also briefly discussed.

Chapter 5 will show why contractors need to understand the nature of the potential contract before they commit to any particular construction project. Also, the details of the critical or "red flag" clauses contained in such contracts will also be analyzed from the point of view of the bidding contractor.

Questions and Problems

1. What is the historic, traditional form of contract upon which the present-day construction industry is based? What are the seven forms of contract discussed in this chapter? Why might a one-of-a-kind contract cause later trouble?
2. What major categories could you expect to find in the documents particularly related to bidding for a typical competitively bid fixed-price contract and what type of information or requirements are contained in each? Would every set of contract documents be likely to contain a General Conditions section? A Supplementary or Special Conditions section? In what three possible places in a set of typical contract documents would you look to be certain that all matters of general importance (other than technical matters and details on the drawings) were examined and noted? Which document part defines the offer element necessary for contract formation?
3. Why is the Davis-Bacon Determination important in a set of contract documents? Where would you expect to find it? Would documents for every project be expected to contain a Davis-Bacon Determination? If not, in which category of projects would you expect to find it?
4. What is the attitude concerning bidding documents held by the AIA? Do most other forms of contract reflect the AIA attitude? Questions 5 and 6 assume that the reader has access to a set of typical federal contract documents for an actual project and to AIA Document A-201 (General Conditions of Contract).
5. With respect to the federal contract, determine the following and cite the section of the documents from which you obtained the answer (place the appropriate abbreviation from the following list in parentheses at the end of each answer):
   [table id=1 /]
   a. What is the date and time of bid opening?
   b. What is the penal sum of the required performance bond?
   c. Will there be a pre-bid conference?
   d. What is the number of days that bids must be held open for acceptance?
   e. Do bidders have to state whether they are a small business concern?
   f. Do bidders have to certify that they do not maintain segregated facilities?
   g. How many milestone completion dates are there?
   h. What is the amount of liquidated damages for each day that each milestone is late?
   i. Is there a clause pertaining to suspension of work?
   j. Does the government have the right to occupy a completed part of the work?
   k. Is there a clause dealing with variations in work quantities?
   l. What is the date of the Davis-Bacon Determination?

m. How long does the contractor have to perform the entire project?
n. How many bid items are there?
o. Is there a clause pertaining to changes in the work?
p. Is there a clause dealing with differing site conditions?
q. How often can the contractor expect to receive progress payments?
r. Is there a clause pertaining to default terminations and excusable delay?
s. Is there a clause for termination of the contract for the convenience of the government?
t. Is there a clause concerning contract disputes?

6. With respect to the AIA document A-201 (General Conditions of Contract), determine the following and indicate where in the document you obtained the answer. At the end of each answer, cite the source in the document by writing in parentheses the article and subarticle.
   a. Is the owner empowered to stop the work?
   b. Is the owner empowered to terminate the contract?
   c. Does this form of contract contemplate or imply a fixed time for completion of the work?
   d. Is the contractor required to indemnify and hold harmless the owner?
   e. Does this contract contemplate changes in the work?
   f. Does this contract provide relief for the contractor’s failure to perform due to conditions beyond the contractor’s control?
   g. Does this contract provide that either the owner or contractor can make a claim against the other for damages suffered?
   h. Is the contractor likely to be liable to the owner for damages caused by late completion?
   i. Does the contract contain the equivalent of the differing site conditions clause found in a federal contract?
   j. Is the contractor required to carry insurance?
   k. Does the contract imply that there could be payments made to the contractor by the owner in the event of owner-caused delays?
   l. Does the contract provide for progress payments?

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1. *See* Sweet, Justin, *Sweet on Construction Industry Contracts: Major AJA Documents* (New York: John Wiley & Sons, 1987). ↵
2. Bond requirements for fixed-price, competitively bid contracts are discussed in Chapter 9. ↵

CHAPTER OVERVIEW

13: Business Ethics

13.1: Corporations and their Social Responsibility

13.1: Corporations and their Social Responsibility

Understanding Corporations and CSR

The subject of this book is *corporate social responsibility* (CSR), a broad term that refers generally to the ethical role of the corporation in society. Before we define CSR more precisely and before we explore in depth a number of case studies that illustrate aspects of the ethical role of corporations, we first need to understand exactly what corporations are, why they exist, and why they have become so powerful.

Today, the global role of corporations rivals that of national or local governments. In 2000, it was reported that, of the 100 largest economic organizations in the world, 51 were corporations and 49 were countries.[1] General Motors, Walmart, Exxon, and Daimler Chrysler all ranked higher than the nations of Poland, Norway, Finland and Thailand (in terms of economic size, comparing corporate revenues with national gross domestic product, or GDP). This trend has continued, and for the past decade, 40 to 50 of the world's 100 largest economic organizations have been corporations, with the rest being national economies. In 2012, Walmart was the twenty-fifth largest economic organization in the world, putting it ahead of 157 countries.[2]

For corporate employees, as for citizens living in communities dominated by large corporations, the corporation is arguably the most important form of social organization. For people such as corporate executives and shareholders, whose lives depend directly on corporations, it is not surprising that company politics often are considered more relevant than national or local politics. Corporations are also a major part of the daily lives of the world's citizens and consumers. For devoted fans of iconic brands like Nike, Apple, Mercedes, or Louis Vuitton, the corporation can occupy a psychological niche very much like that of a member of the family. Indeed, if many teenagers today were forced to choose between an iPhone and a memorable night out celebrating their parents' anniversary, the parents would likely celebrate alone. Similarly, those parents might also be loath to part with their cherished products. Dad would not easily say goodbye to his Chevrolet Corvette or Bose stereo, and Mom might not be easily persuaded to part with her Yamaha piano or Rossignol skis.

At the opposite extreme, for citizens who have been harmed physically or financially by corporations—like the Louisiana or Alaska residents whose beaches were fouled by massive oil spills, or the thousands of small investors who found their life savings wiped out by the Ponzi schemes of Bernie Madoff's investment company—the corporation can seem as dangerous as an invading army, or as destructive as an earthquake.

Despite their vast social role, corporations remain poorly understood by the world's citizens. While school children everywhere are expected to study the structure and history of their nation's government, they are not similarly taught to appreciate the functions, motivations, and inner workings of corporations. Let us begin with a brief review of the nature of corporations.

BP oil rig explosion, photo by United States Coast Guard (2010, public domain). Figure 1.1 The 2010 explosion of a British Petroleum (BP) oil rig off the coast of Louisiana, the cause of the worst environmental disaster in U.S. history.

Why Do Corporations Exist?

There were no corporations in ancient Egypt, Greece, or Rome; or in imperial China or Japan; or among the precolonial kingdoms of the Zulu or Ashanti. The Aztecs and Incas had no corporations, nor did the Sioux, Cherokee, or Navajo. It is true that in some classical and traditional societies there were certain forms of communal and religious organizations that anticipated the organizational capacities of corporations, but strictly speaking, they were not corporations.

Corporations are a relatively modern social innovation, with the first great corporations dating from about 1600. Since then, the growth of corporations has been phenomenal. What explains it? Why has the corporate structure been so successful, profitable, and powerful? Here are a few of the distinguishing characteristics of corporations.

Corporations are Creatures of Law

The first point to make about corporations is that they are not informal organizations or assemblies. In order to exist at all, corporations must be authorized by state or national laws. In their daily operations, corporations are regulated by a specific set of laws. Every country has laws that stipulate how corporations can be created; how they must be managed; how they are taxed; how their ownership can be bought, sold, or transferred; and how they must treat their employees. Consequently, most large corporations have large legal and government affairs departments. Since the laws and rules that may constrain corporations are written and enforced by the government, most corporations consider it of vital importance to seek influence over governmental regulators and lawmakers. In most countries, the very largest corporations have privileged access to top decision makers. The extent and reach of corporate influence over governments is one of the most controversial aspects of corporate existence.

Corporations Raise Capital for Major Undertakings

The first great benefit of corporations is that they provide an organized vehicle for pooling cash and capital from a large number of investors so that they can undertake major enterprises. Thus, one great stimulus to the growth of corporations was the rapid growth of international trade between 1400 and 1700 CE. In that era, sending a large vessel across the oceans was a major financial and logistical undertaking, which was also extremely risky; ships were often lost in storms. These early commercial ventures required such large capital investments that, at first, funding them was only within the reach of royalty. American schoolchildren are taught that the legendary explorer Christopher Columbus needed the royal patronage of Queen Isabella of Spain to support the voyages that led to the “discovery” of the New World. However, as new ocean trading routes were established and the vast potential for profits from trading spices became known, the first modern corporations were formed: the English East India Company, chartered in 1600, and its archrival, the Dutch East India Company, chartered in 1602. These companies are considered the world’s first multinational corporations, and they possessed most of the hallmarks of corporate structure that we see today.

Corporations and Other Business Structures

Not all businesses or companies are public corporations. For example, in the US, it is legal to operate a business in your own name (this is called a *sole proprietorship*) or with partners (a *partnership*). Corporations also come in a bewildering array of forms. Thus, in the US, we have *C corporations*, *S corporations*, *benefit corporations* (also *B corporations*), and *limited liability companies* (LLCs). In the UK, the term *company* is preferred to corporation, and we will notice that the names of most large UK companies followed by the designation *plc* or *PLC* (public limited company), as in Rolls-Royce plc, while smaller companies often have the designation *Ltd* (private limited company). In France, large companies are usually designated *SA* (société anonyme), while smaller ones may be known as *SARL* (sociétéà responsabilité limité). In Germany, large companies are designated *AG* (Aktiengesellschaft), while smaller ones are known as *GmbH* (Gesellschaft mit beschränkter Haftung). In Japan, the corresponding terms are *KK* (kabushiki kaisha) and *YK* (yūgen kaisha).

All of these terms define two basic aspects of corporations: 1) their limited liability (which applies to all corporations), and 2) their status as a *public* or *private* company. Public companies are allowed to sell their shares on public stock markets and tend to be the larger type of company.

The Importance of Limited Liability

Why aren’t all businesses sole proprietorships or partnerships, instead of corporations? The answer is found in the concept of *liability*, which refers to the risk of loss for debts incurred by the business, or for damages caused by the business.

If you start a business as a sole proprietor or via a partnership, you (and/or your partners) are *personally liable* for any debts or damage that can be attributed to the particular business. Let us say that you have $1 million in assets and your good friend has $2 million in assets. Together, you agree to invest $250,000 each in a pizza delivery business (the business will start with $500,000 worth of capital). Unfortunately, in the first month of operation, one of your drivers negligently causes a car accident and severely injures a family driving in another car. The family sues you for their injuries and they obtain a court judgment ordering you to pay $3 million in compensation. Even though you had intended to invest only $250,000 in the business, now your entire fortune and that of your friend are likely to be wiped out in satisfying that court judgment. The same sort of result could arise if your business ran up $3 million in debt that it was unable to pay back. Thus, the founder of a sole proprietorship exposes his/her entire personal assets to the risk that the assets will be seized to satisfy liabilities incurred by the business.

The result can be quite different for a corporation. One of the principal advantages of a corporation, from an investor's point of view, is that the corporation provides a legal a "shield" from liability. A shareholder of a corporation only risks the stock that the shareholder owns. The shareholder's personal assets are not in jeopardy. When a corporation suffers an adverse legal judgment and does not have sufficient funds to satisfy the judgment, the corporation simply goes bankrupt. The party or parties who have been injured cannot sue the owners—the shareholders—of the corporation because the corporation acts as a shield from liability.

Why does society allow the shareholders of a corporation to retreat behind the corporate shield, while we do not allow the same for owners of a so-called mom-and-pop business in the form of a sole proprietorship? The main purpose of the liability-shield is to encourage investment in corporations. People are more willing to invest in a corporation (by acquiring stock) because they need not fear that their personal assets can be seized to satisfy the business's debts or liabilities. The underlying implication is that corporations and corporate investment provide important benefits for society, which explains why governments have been willing to adopt laws that protect and encourage corporate ownership. As many U.S. states learned in the nineteenth century, it can make sound economic sense to attract large corporations because they often become major employers and taxpayers. Corporations may enhance the ability of the local economy to compete with foreign economies that are supported by the productivity of their own corporations.

In many instances the ability of corporations to retreat behind the corporate shield has been controversial. For example, several major airlines (notably American Airlines) have been accused of choosing to declare bankruptcy over finding a way to pay high wages to their pilots and cabin personnel.[3] The airlines were attacked by labor unions as having used the bankruptcy as a tactic to avoid meeting the union's demands for fair wages. Such corporations are able to benefit from an option provided by US bankruptcy law, known as *Chapter 11 reorganization*, which allows them to enter bankruptcy temporarily. The courts appoint a trustee to run the corporation, and the trustee is empowered to take any actions necessary to reduce the corporation's debts, including revoking labor agreements with employees. Such corporations can later "emerge" from bankruptcy with fewer employees or with employees earning lower salaries.

Corporations Permit Wealth Creation and Speculation in Stocks

While all corporations possess limited liability, not all of them are permitted to raise money in the stock market or have their shares traded in stock markets. Here, we find the important distinction between *public corporations*, which may have their shares traded on stock markets, and *private corporations*, which may not have their shares traded on stock markets.

As a rule, large corporations and multinational corporations choose to do business as public corporations because big companies have such enormous capital needs that they may best raise funds by placing stock for sale in public stock markets. However, this is not always the case; there are some very large corporations that choose to remain private, which means that they raise money directly from investors rather than from making stock available on stock markets.

On the whole, ownership of a corporate interest in the form of stocks is more freely and easily transferable than ownership of an interest in a sole proprietorship or partnership. If you want to sell a mom-and-pop store, you generally have to sell the whole business; you cannot sell a small portion when you need to raise money.

If you are one of the members of a partnership and you want to sell your share, you will generally have to get prior approval from the other partners; needing to do so may discourage possible investors because they may not want to go to the trouble of seeking approval from your partners. However, if you inherit a thousand shares of stock in Apple from your wealthy aunt (which, in 2013, would have had an approximate value of $420,000), and you find that you need extra money, you can sell one hundred shares (or about $42,000 worth). Such a transaction is easy because there are lots of investors eager to own Apple shares and you do not need anyone's approval. This ease of transferability also encourages people to invest in stock instead of in other businesses, because it is so easy to sell corporate stock as needed.

When a corporation grows and/or becomes more profitable, the shareholders benefit financially in two ways. First, the corporation will often distribute a portion of its profits to the shareholders in the form of *dividends*, a certain annual payment per share of stock. Second, if a corporation is growing rapidly and is expected to be very profitable in the future, more investors will want to own its stock and the price of that stock will increase. Thus, ownership of stock is an investment vehicle that provides many advantages over other types of investments. For one thing, you can own stock without having to personally take part in the management of the company. In addition, you can sell all or part of your ownership when you need the funds. Finally, if the corporation is very successful, it will not only pay a steady revenue stream—through dividends—but your shares will become more valuable over time.

The advantages of stock ownership as an investment vehicle explains the growth of the world's great stock exchanges, such as the New York Stock Exchange or the Hong Kong Stock Exchange. Stock exchanges are like enormous flea markets for stock, because you can either buy or sell stock there. Unlike the goods available in ordinary markets, though, the price of stocks fluctuates constantly, literally minute by minute. A stock that was worth $10 last year may now be worth as much as $1000 or as little as $0.10. Thus, stock markets are also somewhat like casinos or lotteries, because they allow investors to speculate on the future.

Speculation has its pros and cons. The potential for wealth creation through stock ownership has spawned an important industry that employs hundreds of thousands of people and generates vast profits: financial services. Stock brokerages, investment banks, and trading houses have arisen to provide expert guidance and services to investors.

American colleges and universities have developed a highly collaborative and perhaps even symbiotic relationship with the financial services industry. For one thing, since there are many jobs and professional occupations in financial services, virtually all universities offer courses and majors in finance or financial economics, and many also have graduate business schools that prepare students for careers in the financial services industry.

Perhaps equally importantly, most colleges and universities depend on private and charitable donations to help defray the cost of running the institution and, consequently, to keep tuition rates and fees lower (although many students will find it hard to imagine how tuition could be any higher). When wealthy individuals and corporations make donations or charitable contributions to colleges and universities, they often do so by giving corporate stock. Even when they make a cash donation, the university may find that it is most financially convenient to use that cash to acquire corporate stock. As a result, the largest universities have amassed vast holdings of corporate stock, among other investments. The financial resources of a university are often held in the form of a special trust known as an *endowment*. Universities prefer not to sell off parts of the endowment but rather seek to cover costs by using the interest and dividends generated by the endowment.

At times, the corporate holdings of universities have become quite controversial. For example, in the 1970s and 1980s, a growing student movement called on universities to *divest* (to sell all their stock) in any corporations that did business with the racist apartheid regime that controlled South Africa at that time. Many commentators believe that it was this pressure on corporations that led to the fall of the apartheid regime and the election of South Africa's first black president, Nelson Mandela.

Corporations Can Have Perpetual Existence

It is possible but rare for family-owned businesses to remain sole proprietorships for several generations; more commonly, they eventually become corporations, or they are sold or transferred to a new business operator. Very often, a small business is sold when the founder dies, because the founder's children or heirs either do not want to work in the family business or are not as gifted in that business as was the founder. Even in successful, family-owned businesses where a child or relative of the founder inherits the business, it still happens that after a generation or two, no further family members are qualified (or wish) to join the business, and the business must be sold.

However, corporations are structured from the outset to have a potentially perpetual existence, because corporations do business through their officers and executives rather than through their owners. Although it is possible for owners to have dual roles as shareholders and as executives, it is not necessary. One common scenario is for the founder of the corporation to act as its chief executive officer (CEO) until such time as the corporation becomes so large and successful that the shareholders prefer to transfer management responsibility to an executive with specific professional experience in running a large corporation.

Disadvantages of the Corporate Form

Separation of Ownership and Management Functions

One potential disadvantage of the corporate form (from the point of view of its founders) is that, as the corporation grows, the original founders may lose control and even be pushed out of the corporation by newcomers. This happened to Steve Jobs, the legendary cofounder of Apple, who was pushed out of his leadership role in 1985 by Apple's board of directors, only to return in the mid-1990s and retake his role as CEO. More recently, in 2013, George Zimmer, the founder of the apparel retailer Men's Wearhouse, was terminated as chairman of the board by his own board of directors. This situation can arise because, as a company grows, the founders may be tempted to part with some portion of their equity by selling stock to new investors. Corporations are ultimately controlled by the board of directors, who are voted into office by the shareholders. If a founder allows his or her share of corporate stock to drop beneath 50%, then the founder will no longer be able to elect a majority of the board of directors, and may become subject to termination as an officer by the board. The board of directors is thus a sort of committee that controls the fate of the corporation, and it does this principally by choosing a CEO and supervising the CEO's performance.

Dual Taxation

Although the tremendous growth in the number and size of corporations, and their ever-increasing social role, is due in part to their advantages as an investment vehicle, there are some financial disadvantages worth mentioning. One of the most important is so-called dual taxation, which refers to the practice in most countries of taxing corporate profits twice: once when the corporation declares a certain amount of profit, and again when the corporation distributes dividends to shareholders. The complexity of corporate tax regulations is such that even small corporations must frequently employ specialized accountants and attorneys to handle their tax returns.

Quarterly Financial Reporting for Publicly Traded Corporations

Another disadvantage applies only to publicly traded corporations. Although all corporations are subject to a number of government regulations, the highest degree of regulation applies to public corporations, which raise capital by selling stock in stock markets. Large corporations are often willing to submit to these burdensome regulations because there are strong benefits to being traded on a stock exchange, the most important of which is the ability to raise a great deal of initial funding when the stock is first made available for trade. This first public sale of stock is known in the US an *initial public offering* or *IPO*. In two famous recent examples, Google raised $1.67 billion with its IPO in 2004, and Facebook raised $18 billion with its IPO in 2012.

Source: Toms Shoes, photo by Vivianna Love (CC BY 2.0, 2009) Figure 1.2 A well-worn pair of Toms Shoes;
Toms gives away free shoes to a poor child for every pair it sells.

Despite the allure of additional financing, a company that is traded on a stock market must make a great deal of financial information publicly available, usually on a quarterly basis, four times per year. This obligation can be quite onerous because it requires the corporation to employ a number of internal accountants as well as outside auditors. In addition, the information that is publicly revealed can be of strategic value to the corporation's competitors. Moreover, the need to make frequent quarterly reports on the company's ongoing profitability can have a negative impact on corporate strategy, because executives may become fixated on short-term goals while neglecting long-term goals. In light of these disadvantages, it is not surprising that some public corporations decide to take their shares off the stock markets in a process that is known as *going private*, which is the opposite of an IPO. Other corporations simply avoid going public in the first place. Thus, there are also some very large corporations, such as the multi–billion-dollar engineering firm Bechtel, which prefer to remain private even though they could raise investment capital with an IPO. Such companies prefer to raise capital by other means to avoid the requirements of quarterly earnings reports and therefore not revealing financial information to competitors.

Corporate Social Responsibility

In this book, we will make continual reference to the concept of corporate social responsibility, but it is important to realize that CSR is an evolving concept that can be analyzed from multiple perspectives. The term *CSR* may be used quite differently depending on whether a given speaker is looking at it from the point of view of a corporation, a government, a charity sponsored by the corporation, a citizen employed by the corporation, a citizen who has been harmed by the corporation, or an activist group protesting abuses of corporate power. Let us review key concepts and terms related to CSR, starting with CSR itself.

CSR: Definition

We define CSR simply and broadly as the ethical role of the corporation in society. Corporations themselves often use this term in a narrower, and less neutral, form. When corporations have a director of CSR or a committee in charge of CSR, or when they mention CSR prominently in their mission statements, they are invariably using the term to mean "corporate actions and policies that have a positive impact on society." Corporations refer most frequently to CSR when they speak of civic organizations they support, or to corporate environmental or social policies.

One related term here is corporate "compliance." Not only are large corporations subjected to a host of governmental regulations, many of which have social objectives (such as avoidance of discrimination, corruption, or environmental damage), but many corporations also have set up internal guidelines. In order to make sure that a corporation respects or complies with all these laws, regulations, and norms, both internal and external, corporations increasingly employ "compliance" officers or executives. For example, large fashion and apparel companies frequently place a specific executive in charge of "human rights compliance," to ensure that its clothing was manufactured in safe factories that respect labor laws and do not employ children.

Corporate Philanthropy

Corporate philanthropy refers to a corporation's gifts to charitable organizations. There is an implication that the corporation's donations have no strings attached, which is probably quite rare. At a minimum, most corporations expect that their donations will be publicly attributed to the corporation, thus generating positive public relations. When corporations make large cash gifts to universities or museums, they are usually rewarded with a plaque, or with a building or library named after the donor. Such attributions burnish the corporation's public image, and in such cases we are not dealing with true corporate philanthropy, strictly speaking, but something more in the nature of marketing or public relations.

Stakeholder Capitalism

Stakeholder capitalism refers to a conception of the corporation as a body that owes a duty not only to its *shareholders* (the predominant American view) but also to all of its *stakeholders*, defined as all those parties who have a stake in the performance and output of the corporation. Stakeholders include the company's employees, unions, suppliers, customers, local and national governments, and communities that may be affected by corporate activities such as construction, manufacturing, and pollution. Stakeholder capitalism is a concept that was largely developed in Europe and reflects the widespread European attitude toward corporate governance, which accepts a great degree of government and social oversight of the corporation. The American approach is often described, in contrast, as *laissez-faire* (meaning "leave alone"), in that corporations are granted more freedom of operation than in Europe. One example of a stakeholder approach is in the German practice known as *codetermination*, in which corporations are required to provide a seat on the corporation's board of directors for a union representative. This is intended to oblige the corporation to be more cognizant of worker needs and demands, and to ensure that corporate strategies are not concealed from workers.

Cause-Related Marketing

Cause-related marketing (CRM) refers to a corporation's associating the sales of its products to a program of donations or support for a charitable or civic organization. An example is provided by the famous Red campaign, in which corporations such as Gap pledged to contribute profits from the sale of certain red-colored products to a program for African development and alleviation of AIDS-related social problems. The basic idea of cause-related marketing is that the corporation markets its brand at the same time that it promotes awareness of the given social problem or civic organization that addresses the social problem. Another well-known example is the pink ribbon symbol that promotes breast-cancer awareness and is used prominently in the marketing of special lines of products by many corporations, such as Estée Lauder, Avon, New Balance and Self Magazine. In addition to marketing products with the pink-ribbon symbol, Estee Lauder has made support for breast cancer awareness one of the defining features of its corporate philanthropy. Thus, Estee Lauder also frequently refers to such charitable contributions, currently on the order of $150 million, in its corporate communications and public relations documents.[4]

Sponsorship

Sponsorship refers to a corporation's financial support for sports, art, entertainment, and educational endeavors in a way that prominently attributes the support to the particular corporation. Sponsorship can be considered a form of marketing communications because it seeks to raise awareness and appreciation of the corporation in a given target audience. Arguably, of course, sponsorship benefits society, because society appreciates sports, art, and entertainment. However, in the case of sponsorship, as opposed to philanthropy, the sponsors expect a clear return. Indeed, many corporations carefully analyze the benefits of their sponsorship activities in the same way they measure the impact of their marketing and advertising.

Many prominent global sponsors are companies that find it difficult to advertise through other channels. For example, Philip Morris, the world's largest tobacco company and owner of the Marlboro brand, which finds its global advertising restricted due to a number of bans and limits on tobacco advertising, has invested heavily in sponsorship. Philip Morris has long been the number one sponsor of Formula 1 race car competitions, and it is impossible for a spectator to watch one of these races without observing, consciously or otherwise, huge billboards and banners featuring the famous red-and-white Marlboro logo. Similarly, since alcohol advertising is also increasingly scrutinized, it is not surprising that Budweiser has followed a similar tactic and become the principal sponsor of NASCAR racing. Pharmaceuticals have also become an area subjected to tight advertising and marketing controls; therefore, Pfizer, the world's largest pharmaceutical company, engages in scores of sponsorship activities, notably in its support for the Paralympics, an Olympic-style competition for physically-handicapped athletes.

Sustainability

Sustainability has become such an important concept that it is frequently confused with CSR. Indeed, for some companies it seems that CSR is sustainability. This is perhaps not surprising, given the growing media attention on issues related to sustainability.

Sustainability is a concept derived from environmentalism; it originally referred to the ability of a society or company to continue to operate without compromising the planet's environmental condition in the future. In other words, a sustainable corporation is one that can sustain its current activities without adding to the world's environmental problems. Sustainability is therefore a very challenging goal, and many environmentalists maintain that no corporation today operates sustainably, since all use energy (leading to the gradual depletion of fossil fuels while emitting greenhouse gases) and all produce waste products like garbage and industrial chemicals. Whether or not true sustainability will be attainable anytime in the near future, the development and promotion of sustainability strategies has become virtually an obsession of most large corporations today, as their websites will attest in their inevitable reference to the corporation's sincere commitment to sustainability and responsible environmental practices. No corporation or corporate executive today will be heard to say that they do not really care about the environment. However, if we observe their actions rather than their words, we may have cause for doubt.

We will explore specific cases related to sustainability in later chapters. For now, let us just note that CSR, strictly speaking, is broader than environmental sustainability because it also refers to a corporation's ethical relationship to its employees, shareholders, suppliers, competitors, customers, and local and foreign governments.

More recently, many people have been using the term *sustainability* also to refer to social and political sustainability, which brings the concept closer to that of CSR.

Greenwashing

Greenwashing refers to corporations that exaggerate or misstate the impact of their environmental actions. By the early 1990s a great number of consumer products were being promoted as "environmentally friendly," "eco-friendly," or "green," when in fact there was little or nothing to justify the claims. In 1991, an American Marketing Association study revealed that 58% of environmental ads contained at least one deceptive claim. As a result, many advertising regulatory bodies around the world adopted specific advertising codes to regulate the honesty and accuracy of environmental claims in advertising. For example, in the UK, a producer of a recycling bin advertised that it helped buyers "save the rainforests" by encouraging recycling of plastic and paper products. The advertisement was found to be misleading because most paper products sold in the UK were not made from wood in tropical rainforests, but from wood harvested on northern European tree farms.

In Norway, car manufacturers and dealers are prohibited from claiming that their cars are green, eco-friendly, etc., because in the view of the Norwegian Consumer Ombudsman, it is impossible for cars to be beneficial for the environment; the best they can do is reduce the environmental damage they cause.[5]

Greenwashing is not only a corporate practice but a political one as well, as politicians everywhere promise to undertake actions to improve the environment. Thus, the administration of former US President George W. Bush was widely criticized for promoting legislation under the name of the "Clear Skies Initiative," when in fact the purpose of the legislation was to weaken antipollution measures.[6]

Social Entrepreneurship and Social Enterprise

Social entrepreneurship and social enterprise refer to the use of business organizations and techniques to attain laudable social goals. As we will discuss further in Chapter 6, Blake Mycoskie decided to create TOMS Shoes largely as a reaction to his travels in Argentina, which had exposed him to terrible poverty that left many school-age children without shoes. An important part of the corporate mission of TOMS Shoes lies in its pledge to give away a free pair of shoes for every pair purchased by a customer. TOMS Shoes’ model has been imitated by many others, including the popular online eyewear brand, Warby Parker.

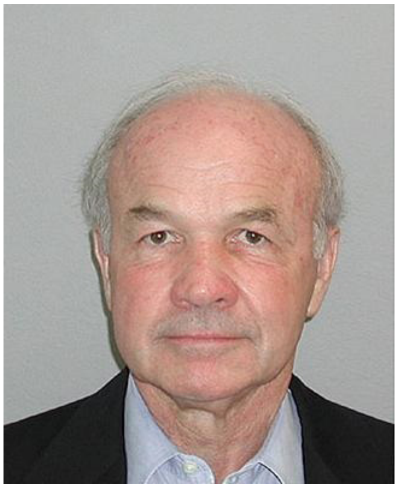
The difference between social entrepreneurship and CSR is that, with social entrepreneurship, the positive social impact is built into the mission of the company from its founding. Other examples of social entrepreneurship include The Body Shop, Ben & Jerry’s ice cream, and Newman’s Own. The Body Shop was founded by noted activist Anita Roddick who insisted that all products be derived from ingredients which were natural, organic, and responsibly sourced. Her employment policies famously allowed every employee to take off one day a month from work to engage in social or community projects. Similarly, Ben & Jerry’s was founded to promote the use of organic, locally-produced food. The company’s founders insisted on a policy that executives earn no more than seven times the salary of factory line-workers (although this policy was eventually relaxed when it became difficult to recruit a competent CEO at those wages). Ben & Jerry’s engaged in a number of high-profile political activities in which they encouraged their employees to participate, such as protesting the building of the Seabrook nuclear power plant in Vermont. Newman’s Own was founded by film actor Paul Newman and his friend A. E. Hotchner with the goal of selling wholesome products and giving away 100% of the profits to charitable ventures. To date, Newman’s Own has given away over $200 million.

Social Marketing

Social marketing refers to the use of business marketing techniques in the pursuit of social goals. Often, governments and nonprofit organizations make use of social marketing to make their points more forcefully and effectively to a wide audience. Classic examples are the extremely powerful TV commercials warning of the dangers of unsafe driving or of failing to use seatbelts. Cinematic techniques are employed to portray dramatic, arresting images of crumpled cars and bodies, children and mothers crying. The source of social marketing advertisements is usually a local government or nonprofit organization.

Social marketing is usually used to try to convince citizens to drive more safely, eat better, report child and domestic abuse, and avoid various forms of criminality and drug use. As with ordinary advertising, social marketing can seem overdone or maudlin, and some social marketing ads have been mocked or considered silly. For example, former First Lady Nancy Reagan participated in a social marketing campaign that urged young people to “Just Say No” to drugs, an approach which was ridiculed as simplistic by many. Noted radical activist Abbie Hoffman said that telling drug users to “just say no” to drugs was like telling manic-depressives to “just cheer up.” Despite that, drug use in America declined over the time period that the campaign was in progress, though there is no evidence that any part of this decline was due to the campaign.

Business Ethics



Source: United States Marshals Service, 2004, public domain
Figure 1.3 The mug shot of former Enron top executive Ken Lay. Lay was eventually convicted on 10 counts of fraud; while awaiting sentencing of up to 100 years in prison he died of a heart attack in 2006.

Business ethics is an academic discipline closely related to CSR, but one that tends to use the tools of philosophy to formally analyze the ethical role of individuals and corporations. Although the terms are quite similar, there are differences of nuance. For example, although academics who study business ethics tend to focus on corporations, the term itself could also apply to the ethical dilemmas of sole proprietors or of individuals involved in commercial situations, such as a private party trying to sell a used car that he knows has a hidden mechanical flaw. While the term *CSR* tends to be used by corporations and social entrepreneurs in a way that assumes a positive connotation, *business ethics* is used in a more neutral and even critical fashion, as one might expect, given the perspective of writers who are not beholden to corporations. Indeed, when the media uses the term *business ethics*, it is often in a negative sense, to draw attention to instances of deception or fraud on the part of corporations or executives.[7]

White-Collar Crime

White-collar crime refers to fraudulent or financially-oriented criminal activities by high-status professionals or businesspeople. The term *white-collar crime* was coined by sociologist Edwin Sutherland, who defined it as a "crime committed by a person of respectability and high social status in the course of his occupation" in a 1939 speech entitled "The White Collar Criminal." Although the term applies to financial fraud committed by individuals who are not associated with corporations, there is a strong linkage to corporations in actual practice because corporate executives are often well-placed to commit crimes of fraud and corruption. However, a distinction should be drawn between white-collar crime and corporate crime, which refers to crimes for which the corporation itself is responsible. In many cases, such as in violations of US laws against bribing foreign government officials, it may be unclear whether the matter is better classified as white-collar crime or corporate crime. In the law, it may depend on whether the corporation's senior executives were aware of and supported the acts of criminality.

While there is a popular perception that punishments for wealthy white-collar criminals are less severe than for poor and middle-class criminals, the situation appears to have changed in light of the severe penalties for white-collar crime mandated by the 2002 Sarbanes–Oxley Act, which was adopted by the US Congress in the wake of the notorious Enron scandal. As a result, former Enron CEO Jeffrey Skilling, the architect of Enron's frauds, was sentenced to 24 years in prison. Bernie Ebbers, former CEO of WorldCom, was convicted of fraudulent misstating of billions of dollars of WorldCom earnings, resulting in a sentence of 25 years. More recently, Bernie Madoff, whose vast Ponzi scheme defrauded investors of up to $65 billion, was sentenced in 2009 to 150 years in prison for his crimes, effectively a life sentence without possibility of parole.

Topic for Debate: Regulation of Corporations

It is one of the basic premises of this book that we do not want you merely to read and assimilate the material. We want you to engage it personally in an effort to develop and refine your own opinions. Therefore, each chapter will feature a topic for debate (more detailed rules and suggestions for debate will be set forth in the next chapter). Most chapters will feature an in-depth case study based on a real-life business situation, or a fictionalized account of a real business situation or social controversy. In this chapter we will use what we will call a "mini-case study"—a sort of thought experiment, based on a simple set of facts as follows:

Mini-Case Study: The Case of the Undecided Voter

Your close friend, Jane Goodie, is a college student who has registered to vote in her first election. Jane's father has been a lifelong Republican voter and Jane's mother a lifelong Democrat. As Jane grew up, she often listened to her parents debating politics at the dinner table. More than once, Jane found herself disconcerted and discouraged by the appearance of biased thinking on the part of one or both of her parents; they rarely seemed to agree or listen to each other in their political debates. Sometimes, Jane even wondered to herself, "Why do they vote at all, since their votes obviously just cancel each other out?" However, since her parents have strongly urged her to vote as soon as she is old enough, and since they have also urged to make up her own mind about which candidate to choose, she is looking forward to expressing her own views at the ballot box. But first she must make up her mind.

Since this is not a presidential election year, the most important office up for election is that of Senator. Both senatorial candidates are very impressive and illustrious people: One is a graduate of Harvard Law School, the other of Yale Law School. The Democratic, or "liberal," candidate pursued an impressive career as an environmental lawyer before being elected to a position as mayor of one of the leading cities in your state. The Republican, or "conservative," candidate enjoyed an impressive career as an advisor to a number of successful start-up companies before also being elected to a position as a mayor of one of the leading cities in your state.

Both candidates appear to be exceptionally bright, eloquent, and dedicated to public service. In this particular campaign, they both espouse very similar views on foreign policy and social policy. In fact, the main difference between the candidates comes down to one thing: their attitude toward government regulation of business, and of large corporations in particular. The Democratic candidate, citing recent examples of fraud, pollution, and layoffs at major corporations, is calling for tighter regulation of corporations. The Republican candidate, citing the importance of the business sector as a major taxpayer and creator of jobs, calls for a loosening and reduction of government regulation of business.

Your friend does not know who to vote for, but believes that she should decide on the basis of the single issue on which the candidates differ: the regulation of business. Your friend asks for your advice.

You are therefore asked to develop the strongest reasons for supporting one of the following two possible responses:

Affirmative Position

Jane should vote for the Democratic candidate.

Possible Arguments:

- It is better to maintain tight regulation of businesses and corporations, given their propensity to cause or contribute to social harms.
- Corporations are able to lobby governments to shield themselves from regulation.
- Corporations are able to attain more power and influence than citizens.

Negative Position

Jane should vote for the Republican candidate.

Possible Arguments:

- It is better to liberate businesses and corporations from onerous and expensive government regulation.
- Corporations are major employers and job-creators.
- Corporations can undertake enormous projects beyond the scope of small business or individuals.
- Corporations stimulate research and innovation.

Readings

The readings below are meant only to stimulate your thinking about possible perspectives to take on corporations. Please supplement them with your own research.

1.1 The Corporation as a “Psychopathic” Creature

Bakan, Joel. “Business as Usual,” in The Corporation: The Pathological Pursuit of Profit and Power, 28-59. New York: Simon and Schuster, 2004.

Bakan, Joel. “The Externalizing Machine,” in The Corporation: The Pathological Pursuit of Profit and Power, 60-84. New York: Simon and Schuster, 2004.

Business leaders today say their companies care about more than profit or loss, that they feel responsible to society as a whole, not just to their shareholders. Corporate social responsibility is their new creed, a self-conscious corrective to earlier greed-inspired visions of the corporation. Despite this shift, the corporation itself has not changed. It remains, as it was at the time of its origins as a modern business institution in the middle of the nineteenth century, a legally designated “person” designed to valorize self-interest and invalidate moral concern. Most people would find its “personality” abhorrent, even psychopathic, in a human being, yet curiously we accept it in society’s most powerful institution. The troubles on Wall Street today, beginning with Enron’s spectacular crash, can be blamed in part on the corporation’s flawed institutional character, but the company was not unique for having that character. Indeed, all publicly traded corporations have it, even the most respected and socially acceptable….

As a psychopathic creature, the corporation can neither recognize nor act upon moral reasons to refrain from harming others. Nothing in its legal makeup limits what it can do to others in pursuit of its selfish ends, and it is compelled to cause harm when the benefits of doing so outweigh the costs. Only pragmatic concern for its own interests and the laws of the land constrain the corporation’s predatory instincts, and often that is not enough to stop it from destroying lives, damaging communities, and endangering the planet as a whole…. Far less exceptional in the world of the corporation are the routine and regular harms caused to others—workers, consumers, communities, the environment—by corporation’s psychopathic tendencies. These tend to be viewed as inevitable and acceptable consequences of corporate activity—“externalities” in the coolly technical jargon of economics.

“An externality,” says economist Milton Friedman, “is the effect of a transaction…on a third party who has not consented to or played any role in the carrying out of that transaction.” All the bad things that happen to people and the environment as a result of corporations’ relentless and legally compelled pursuit of self-interest are thus neatly categorized by economists as externalities—literally, other people’s problems.

1.2 “EPA Costs US Economy $353 Billion per Year”

Young, Ryan. “EPA costs US economy $353 billion per year.” The Daily Caller. Last modified December 27, 2012. http://dailycaller.com/2012/12/27/epa-costs-us-economy-353-billion-per-year/ .

Transparency is the lifeblood of democracy. Washington needs more of it, especially in the all-too-opaque world of regulation. The Environmental Protection Agency (EPA), for example, is the most expensive federal regulatory agency. Its annual budget is fairly modest in Beltway terms, at a little less than $11 billion, but that’s not where the vast majority of its costs come from. Complying with EPA regulations costs the US economy $353 billion per year—more than 30 times its budget—according to the best available estimate. By way of comparison, that is more than the entire 2011 national GDPs of Denmark ($332 billion) and Thailand ($345 billion)…

In the last edition of the Unified Agenda, the fall 2011 edition, the EPA had 318 rules at various stages of the regulatory process. Nobody outside the agency knows how many rules it currently has in the pipeline. All in all, 4,995 EPA rules appeared in the Winter Unified Agenda from 1999–2011. Over the same period, 7,161 EPA final rules were published in the *Federal Register*. That means more than 2,000 final rules, which have the force of law, came into effect without first appearing in the Unified Agenda. This could indicate an important transparency problem.

That’s just the EPA’s *annual* flow of regulations. The agency has existed for more than 40 years. How many total rules does it currently have in effect? Again, the answer doesn’t come from the agency. Earlier this year, the Mercatus Center’s Omar Al-Ubaydli and Patrick A. McLaughlin ran text searches through the entire *Code of Federal Regulations* (CFR) for terms such as “shall,” “must,” “prohibited,” and the like. The CFR Title covering environmental protection alone contains at least 88,852 specific regulatory restrictions. The number could be as high as 154,350….

Justice Louis Brandeis correctly believed that sunshine is the best disinfectant. With high regulatory costs contributing to a stagnant economic recovery, it is well past time to shine more light on regulatory agencies. Annual agency report cards would make a good start.

1.3 Press Release from the US Consumer Product Safety Commission

Consumer Product Safety Commission. “Port Surveillance News: CPSC Investigators Find, Stop Nearly 650,000 Unsafe Products at the Start of Fiscal Year 2012.” News Release. April 5, 2012. https://www.cpsc.gov/en/Newsroom/News-Releases/2012/Port-Surveillance-News-CPSC-Investigators-Find-Stop-Nearly-650000-Unsafe-Products-at-the-Start-of-Fiscal-Year-2012/.

Investigators Stop Nearly 650,000 Unsafe Products

Investigators with the US Consumer Product Safety Commission (CPSC) prevented more than half a million violative and hazardous imported products from reaching the hands of consumers in the first quarter of fiscal year 2012.

Working with US Customs and Border Protection (CBP) agents, CPSC port investigators successfully identified consumer products that were in violation of US safety rules or found to be unsafe. CPSC and CBP teamed up to screen more than 2,900 imported shipments at ports of entry into the United States. As applicable, these screenings involved use and abuse testing or the use of an X-ray fluorescence (XRF) analyzer. Their efforts prevented more than 647,000 units of about 240 different non-complying products from reaching consumers, between October 1, 2011 and December 31, 2011.

Topping the list of products stopped were children’s products containing levels of lead exceeding the federal limits, toys and other articles with small parts that present a choking hazard for children younger than 3 years old, and toys and child-care articles with banned phthalates.

In addition to violative toys and other children’s products, items stopped at import included defective and dangerous hair dryers, lamps, and holiday lights.

“We mean business when it comes to enforcing some of the toughest requirements for children’s products in the world. If an imported product fails to comply with our safety rules, then we work to stop it from coming into the United States,” said Chairman Inez Tenenbaum. “Safer products at the ports means safer products in your home.”

During fiscal year 2011, CPSC inspected more than 9,900 product shipments at the ports nationwide and stopped almost 4.5 million units of violative or hazardous consumer products from entering the stores and homes of US consumers.

CPSC has been screening products at ports since it began operating in 1973. In 2008, the agency intensified its efforts with the creation of an import surveillance division.

1.4 “Costs of Air Pollution in the U.S.”

Taylor, Timothy. “Costs of Air Pollution in the U.S.,” *Conversable Economist* (blog), November 7, 2011, http://conversableeconomist.blogspot.com/2011/11/costs-of-air-pollution-in-us.html.

What costs does air pollution impose on the U.S. economy? Nicholas Z. Muller, Robert Mendelsohn, and William Nordhaus tackle that question in the August 2011 issue of the *American Economic Review*. Total “gross external damages” the six “criterion” air pollutants in 2002—sulfur dioxide, nitrogen oxides, volatile organic compounds, ammonia, fine particulate matter, and coarse particulate matter—was $182 billion.

Since GDP was about $10.5 trillion in 2002, the cost of air pollution was a bit under 2% of the total. The effects included in the model calculations are adverse consequences for human health, decreased timber and agriculture yields, reduced visibility, accelerated depreciation of materials, and reductions in recreation services.

The sectors with the biggest air pollution costs measured in terms of “gross external damages” (GED) (counting the same six pollutants but again not counting carbon emissions) are utilities, agriculture/forestry, transportation, and manufacturing.

If one looks at the ratio of gross economic damages to value-added in the sector, agriculture/forestry and utilities lead the way by far with ratios above one-third. Manufacturing has fairly high gross external damages, but the GED/VA ratio for the sector as a whole is only 0.01.

To me, a lesson that emerges from these calculations is that the costs of air pollution and of burning fossil fuels are very high, both in absolute terms and compared to the value-added of certain industries, even without taking carbon emissions into account. Environmentalists who are discouraged by their inability to persuade more people of the risks of climate change might have more luck in reducing carbon emissions if they deemphasized that topic—and instead focused on the costs of these old-fashioned pollutants.

1.5 “Over-Regulated America”

“Over-regulated America: The home of laissez-faire is being suffocated by excessive and badly written regulation.” The Economist. Last modified February 8, 2012. http://www.economist.com/node/21547789 .

Synthesis Questions

The most productive discussions and debates are those that open our eyes to different perspectives and different ways of thinking. While we may not change our initial opinions, we may emerge with an enhanced understanding of the perspectives of others, or of the complexity of a particular issue.

So we suggest that at the end of each chapter you answer a few questions in a way that allows you to “synthesize” your discussions and readings—by bringing together the strongest parts of each side of the argument—so as to arrive at a deeper, more nuanced understanding of the issues involved.

Clearly, the ethical role of corporations is a vast, complex topic and allows for a great diversity of opinions. Here are three initial synthesis questions for further reflection:

Synthesis Questions

1. Are corporations on the whole good for society?
2. Do you personally like or distrust corporations? Why?
3. How should society regulate corporations?

Endnotes

1. Sarah Anderson and John Cavanagh, “Top 200: The Rise of Corporate Global Power,” *Institute for Policy Studies*, December 4, 2000. accessed December 6, 2014, http://www.ips-dc.org/top_200_the_rise_of_corporate_global_power/.

2. Vincett Trivett, “25 US Mega Corporations: Where They Rank If They Were Countries,” *Business Insider*, June 27, 2011, accessed December 6, 2014, http://www.businessinsider.com/25-corporations-bigger-tan-countries-2011-6?op=1.

3. Steven Pearlstein, “Two Can Play the Airline Bankruptcy Game,” *Washington Post*, 28 April 2012, accessed November 28, 2014, www.washingtonpost.com/business/steven-pearlstein-two-can-play-the-airline-bankruptcy-game/2012/04/27/gIQAJ239nT_story.html.

4. “The Estee Lauder Companies Breast Cancer Awareness Campaign,” accessed November 28, 2014, bcacampaign.com/.

5. “Norway Outlaws ‘Green’ Cars,” *TerraPass,* September 11, 2007, accessed December 6, 2014, terrapass.com/politics/norway-outlaws/.

6. US Senator Patrick Leahy, “The Greenwashing of the Bush Anti-Environmental Record on the President’s Earth Day Visits to Maine and Florida,” (statement on the Senate floor, Washington, DC, April 26, 2004).

7. See Sebastian Bailey, “Business Leaders Beware: Ethical Drift Makes Standards Slip,” *Forbes*, May 15, 2013, accessed December 6, 2014, http://www.forbes.com/sites/sebastianbailey/2013/05/15/business-leaders-beware-ethical-drift-makes-standards-slip/.

CHAPTER OVERVIEW

14: International Business

14.1: Overview

14.2: Readings

14.3: Reading- Dunkin’ Brands – Dunkin’ Donuts and Baskin-Robbins – Making Local Global

14.4: Discussion Assignment- Dunkin’ Brands – Dunkin’ Donuts and Baskin-Robbins – Making Local Global

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14.1: Overview

In this module we will explore culture and how it impacts global business efforts.

LEARNING OUTCOMES

After you complete the required assignments you will be able to:

- Define culture
- Identify the implications of culture on business operations
- Give examples of cultural differences among countries

14.2: Readings

INSTRUCTIONS for this Module's "Readings"

For this Module, you will not have traditional "readings." Instead, when you click this link Presentation: Culture, it will launch an online Module/Presentation from Michigan State University. You do NOT have to complete the entire Module, so please read the following instructions before you do more work than you have to do.

1. You are responsible for viewing the following:
    1. Section 1: Presentation Slides 1 – 14. The "QUIZ" at the end of this section is NOT REQUIRED.
    2. Section 2: Presentation Slides 18 – 17. The "QUIZ" at the end of this section is NOT REQUIRED.
    3. Section 3: Presentation Slides 30 – 19. The "QUIZ" at the end of this section is NOT REQUIRED.
    4. Section 4: Presentation Slides 41 – 50. The "QUIZ" at the end of this section is NOT REQUIRED.
2. This is a narrated video presentation, and should not take you very long to complete. There are some additional resources that are available from the "Related GlobalEdge Resources" link in the Module Menu if you want/need additional information.

14.3: Reading- Dunkin’ Brands – Dunkin’ Donuts and Baskin-Robbins – Making Local Global

High-tech and digital news may dominate our attention globally, but no matter where you go, people still need to eat. Food is a key part of many cultures. It is part of the bonds of our childhood, creating warm memories of comfort food or favorite foods that continue to whet our appetites. So it’s no surprise that sugar and sweets are a key part of our food focus, no matter what the culture. Two of the most visible American exports are the twin brands of Dunkin’ Donuts and Baskin-Robbins.

Owned today by a consortium of private equity firms known as the Dunkin’ Brands, Dunkin’ Donuts and Baskin-Robbins have been sold globally for more than thirty-five years. Today, the firm has more than 14,800 points of distribution in forty-four countries with $6.9 billion in global sales.

After an eleven-year hiatus, Dunkin’ Donuts returned to Russia in 2010 with the opening of twenty new stores. Under a new partnership, “the planned store openings come 11 years after Dunkin’ Donuts pulled out of Russia, following three years of losses exacerbated by a rogue franchisee who sold liquor and meat pies alongside coffee and crullers.” [1] Each culture has different engrained habits, particularly in the choices of food and what foods are appropriate for what meals. The more globally aware businesses are mindful of these issues and monitor their overseas operations and partners. One of the key challenges for many companies operating globally with different resellers, franchisees, and wholly owned subsidiaries is the ability to control local operations.

This wasn’t the first time that Dunkin’ had encountered an overzealous local partner who tried to customize operations to meet local preferences and demands. In Indonesia in the 1990s, the company was surprised to find that local operators were sprinkling a mild, white cheese on a custard-filled donut. The company eventually approved the local customization since it was a huge success. [2]

Dunkin’ Donuts and Baskin-Robbins have not always been owned by the same firm. They eventually came under one entity in the late 1980s—an entity that sought to leverage the two brands. One of the overall strategies was to have the morning market covered by Dunkin’ Donuts and the afternoon-snack market covered by Baskin-Robbins. It is a strategy that worked well in the United States and was one the company employed as it started operating and expanding in different countries. The company was initially unprepared for the wide range of local cultural preferences and habits that would culturally impact its business. In Russia, Japan, China, and most of Asia, donuts, if they were known at all, were regarded more as a sweet type of bakery treat, like an éclair or cream puff. Locals primarily purchased and consumed them at shopping malls as an “impulse purchase” afternoon-snack item and not as a breakfast food.

In fact, in China, there was no equivalent word for “donut” in Mandarin, and European-style baked pastries were not common outside the Shanghai and Hong Kong markets. To further complicate Dunkin’ Donuts’s entry into China, which took place initially in Beijing, the company name could not even be phonetically spelled in Chinese characters that made any sense, as Baskin-Robbins had been able to do in Taiwan. After extensive discussion and research, company executives decided that the best name and translation for *Dunkin’ Donuts* in China would read *Sweet Sweet Ring* in Chinese characters.

Local cultures also impacted flavors and preferences. For Baskin-Robbins, the flavor library is controlled in the United States, but local operators in each country have been the source of new flavor suggestions. In many cases, flavors that were customized for local cultures were added a decade later to the main menus in major markets, including the United States. Mango and green tea were early custom ice cream flavors in the 1990s for the Asian market. In Latin America, *dulce de leche* became a favorite flavor. Today, these flavors are staples of the North American flavor menu.

One flavor suggestion from Southeast Asia never quite made it onto the menu. The durian fruit is a favorite in parts of Southeast Asia, but it has a strong, pungent odor. Baskin-Robbins management was concerned that the strong odor would overwhelm factory operations. (The odor of the durian fruit is so strong that the fruit is often banned in upscale hotels in several Asian countries.) While the durian never became a flavor, the company did concede to making ice cream flavored after the *ube*, a sweetened purple yam, for the Philippine market. It was already offered in Japan, and the company extended it to the Philippines. In Japan, sweet corn and red bean ice cream were approved for local sale and became hot sellers, but the two flavors never made it outside the country.

When reviewing local suggestions, management conducts a market analysis to determine if the global market for the flavor is large enough to justify the investment in research and development and eventual production. In addition to the market analysis, the company always has to make sure they have access to sourcing quality flavors and fruit. Mango proved to be a challenge, as finding the correct fruit puree differed by country or culture. Samples from India, Hawaii, Pakistan, Mexico, the Philippines, and Puerto Rico were taste-tested in the mainland United States. It seems that the mango is culturally regarded as a national treasure in every country where it is grown, and every country thinks its mango is the best. Eventually the company settled on one particular flavor of mango.

A challenging balance for Dunkin' Brands is to enable local operators to customize flavors and food product offerings without diminishing the overall brand of the companies. Russians, for example, are largely unfamiliar with donuts, so Dunkin' has created several items that specifically appeal to Russian flavor preferences for scalded cream and raspberry jam.[3]

In some markets, one of the company's brands may establish a market presence first. In Russia, the overall "Dunkin' Brands already ranks as a dessert purveyor. Its Baskin-Robbins ice-cream chain boasts 143 shops there, making it the No. 2 Western restaurant brand by number of stores behind the hamburger chain McDonald's Corp." [4] The strength of the company's ice cream brand is now enabling Dunkin' Brands to promote the donut chain as well.

Opening Case EXERCISES

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. If you were a manager for Baskin-Robbins, how would you evaluate a request from a local partner in India to add a sugar-cane-flavored ice cream to its menu? What cultural factors would you look at?

2. Do you think Dunkin' Brands should let local operators make their own decisions regarding flavors for ice creams, donuts, and other items to be sold in-country? How would you recommend that the company's global management assess the cultural differences in each market? Should there be one global policy?

[1] Kevin Helliker, "Dunkin' Donuts Heads Back to Russia," Wall Street Journal, April 27, 2010, accessed February 15, 2011,http://online.wsj.com/article/SB1000...044839374.html.

[2] David Jenkins (former director, International Operations Development, Allied-Domecq QSR International Ltd.), interview with the author, 2010.

[3] Kevin Helliker, "Dunkin' Donuts Heads Back to Russia," Wall Street Journal, April 27, 2010, accessed February 15, 2011,http://online.wsj.com/article/SB1000...044839374.html.

[4] Kevin Helliker, "Dunkin' Donuts Heads Back to Russia," Wall Street Journal, April 27, 2010, accessed February 15, 2011,http://online.wsj.com/article/SB1000...044839374.html.

14.4: Discussion Assignment- Dunkin' Brands – Dunkin' Donuts and Baskin-Robbins – Making Local Global

For this module you will complete a written assignment on Dunkin' Donuts and the company's global presence. In order to complete this assignment you will need to:

1. **READ** the previous case study: Dunkin Brands Making Local Global
2. **VISIT** the Dunkin' Donuts website at http://www.dunkindonuts.com. Scroll to the BOTTOM of the web page and find the link that says: "Global Presence" which will allow you to get more information about the extent to which Dunkin' Donuts has gone global.
3. **GO TO** at least **ONE** of the countries listed in this area and find out how "Local goes Global."**PICK ONE COUNTRY/LOCATION** of Dunkin' Donuts as the basis for your discussion for Question #1.
4. **DISCUSSION BOARD**: You have read the Dunkin' Donuts case and researched on the corporate website how Dunkin' "Goes Global." You will base your INITIAL and TWO RESPONSE POSTS on the following questions:
    1. What are some of the **most interesting local adaptations** Dunkin' Donuts has made based on your research?
    2. What cultural factors do you think Dunkin' Donuts looked at when they made these adaptations?
    3. Do you think Dunkin' Brands should let local operators make their own decisions regarding flavors for ice creams, donuts, and other items to be sold in-country?
    4. How would you recommend that the company's global management assess the cultural differences in each market?
    5. Should there be one global policy?

NOTE: This is not an assignment where there is a great deal of "research." The nature of the questions is directed towards what YOU think! You cannot Google the answer to these questions!

CHAPTER OVERVIEW

15: Business Communication

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15.1: Guidelines for Ethical Communication

Learning Objectives

- Identify key guidelines for ethical business communication

It's not enough for a communicator to craft a message that's clearly understood by his audience, leveraging the seven principles of business communication:

- Clear
- Concise
- Objective
- Consistent
- Complete
- Relevant
- Understanding of Audience Knowledge

Figure 1. How might ethics affect the decisions you make as an employee?

In reality, if you adhere to the seven principles, you will communicate ethically. For instance, if you craft a message that is not clear and concise, and you use tricky language that manipulates your consideration for your audience's knowledge, then you are not being ethical. If you're not being objective, and you are trying to communicate your opinion (or the opinion of others) as fact, then you are not being ethical. If you purposely do not disclose complete information, then you are not being ethical.

You don't have to look too far today to see examples of unethical communication; they're all over the media. "Fake news" media sites abound, even though social media outlets like Facebook and Twitter are making efforts to prevent them from being posted and shared. Is fake news ethical?

Daily World Update

Daily World Update is a fake news site that recently posted an article called "Black Woman Who Won Georgia Primary Arrested for Election Fraud." The story talks about Michelle Agabobo Willford, running for governor of Georgia, who paid for "tens of thousands of votes" by promising free welfare. This story runs parallel to a real-life story of Stacy Abrahms. Abrahms recently won a primary elections as a candidate for Georgia governor (without paying for votes). Her success made news, because, if she wins, she will be the nation's first black female governor.

Now, the *Daily World Update* claims to be a satirical site, and this article about Michelle Agabobo Willford fake, but if this news story is shared on social media, people just see the headline and jump to their own conclusions about what happened in Georgia. Is this ethical communication? Does it meet those seven business communication objectives above?

General Motors

General Motors now admits that over 100 people died because of faulty ignition switches that were not recalled. In an article in *Forbes* magazine, reporter Carmine Gallo claimed that "Two Misleading Words Triggered GM's Catastrophic Communication Breakdown." The article discusses that the ignition issue was mis-labeled as a "customer convenience" issue and therefore didn't get the attention it needed. Data about the issue was buried in the back of a 72-page PowerPoint deck. These were communication choices made by human beings. Was it a mistake, or was it unethical?

The seven principles of business communication should be enough to keep your messages ethical. But if you want further guidance as to what is and is not ethical in business communication, the International Association of Business Communicators outlines a code of ethics for all its members:[1]

- I am honest—my actions bring respect for and trust in the communication profession.
- I communicate accurate information and promptly correct any errors.
- I obey laws and public policies; if I violate any law or public policy, I act promptly to correct the situation.
- I protect confidential information while acting within the law.
- I support the ideals of free speech, freedom of assembly, and access to an open marketplace of ideas.
- I am sensitive to others' cultural values and beliefs.
- I give credit to others for their work and cite my sources.
- I do not use confidential information for personal benefit.
- I do not represent conflicting or competing interests without full disclosure and the written consent of those involved.
- I do not accept undisclosed gifts or payments for professional services from anyone other than a client or employer.
- I do not guarantee results that are beyond my power to deliver.

If you have any question regarding the ethics of a particular message, these guidelines should serve you well. Betraying the trust of your audience is lethal to effective communication.

Principles of Ethical Decision Making

After ethical intensity, a thoughtful manager will consider the principles that might apply to an issue. There is no one set of principles to check off, but the seven listed here are common to most people.

- **Legal and regulatory requirements** set the minimum standard for behavior. Any company or individual can disagree with the law, but given the consequences, such disagreement must be done carefully. The Hobby Lobby stores refused, on religious grounds, to follow the Affordable Care Act requirements for certain health benefits. The US Supreme Court found in their favor in 2014.
- **Long-term self-interest** means the pursuit of outcomes that will benefit the self in the long run. For example, a company must make choices to ensure its continued existence. The costs and harm from failure are substantial.
- **Personal virtue** refers to conformity to a standard of righteousness. You should make choices that are honest and truthful individually. The good of the company does not justify lying.
- **Utilitarianism** seeks the greatest benefit for the maximum number of people. This is often difficult to judge over large groups of people.
- **Individual rights** are related to the freedom to act and think without punishment through regulatory, legal, or societal means. For example, we make individual health decisions to smoke or drink beverages loaded with sugar even though the health costs are borne by many through private and government insurance programs.
- **Distributive justice** is the fairness of the outcomes. That is, how are the benefits shared or distributed among the individuals in a group? The US market system can have winner-take-all outcomes. Our welfare system redistributes a little to the losers in the market game who are also part of our society.
- **Religious injunction** is the main moral and ethical guide for many people.

Watch the following video for an overview of the ethical decision making process:

A YouTube element has been excluded from this version of the text. You can view it online here: pb.libretexts.org/bcsfm/?p=62

1. International Association of Business Communicators, "IABC Code of Ethics for Professional Communicators."

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- Video: Integrating Ethics: Ethical Decision-Making. **Provided by**: Academic Technologies (AT) at The University of Texas at El Paso (UTEP), in partnership with the Texas Holocaust and Genocide Commission. **Located at**: https://youtu.be/IwK-CshmH7M. **License**: *CC BY: Attribution*

15.2: Being Ethical Online

Learning Objectives

- Describe how to communicate ethically online

If it says so online, it must be true!

That's the joke of researching and reporting facts you find on the internet. If you believe everything you see out there, then you might believe that the United States has a giant "earthquake gun" and that Bat Boy was an advisor to the Clinton White House. Some of these less-than-subtle fibs are easy to spot and debunk. But other so-called facts aren't as easy to spot and can sneak into our business communications if we're not diligent in our fact checking.

Internet ethics are multi-faceted and far reaching. There are ethics to consider when you post to the internet. There are more ethics to consider when you use information you found on the internet. The internet provides all kinds of opportunity to trip up good communicators and drop them right into the middle of an ethical conundrum. Post information online with caution, and always be skeptical about the information you find there!

Posting

Don't post non-factual information on the internet, and if you do, promptly correct errors. When you post information online on behalf of your business, you owe your co-workers and all your external readers truthful information. When you communicate, you work hard to develop a relationship of trust with your audience, whether they're reading you or listening to you speak. Passing along information that's not trustworthy is damaging to your reputation as much as it's damaging to your message.

Don't post questionable information anonymously. Just because you don't put your name on it doesn't mean you're not responsible for facilitating an incorrect, untruthful message. Again, you're damaging the level of trust you've developed for yourself as well as a reader's trust in the information.

Be careful about sharing proprietary information, information that violates patient confidentiality or attorney-client privilege. We talked a little earlier about how the lines between professional and personal communications are blurring. It's easy to make a mistake and post a picture of yourself and your patient and say, "That kidney transplant has been very successful!" Even if you work for the Cleveland Clinic, that's not appropriate unless you have the correct forms from the patient saying it's okay to release that information. In addition, if you're a lawyer and your client posts something on your Facebook wall about his trial, that's also not terribly ethical. Don't leave it up on your wall. Take it down and contact your client by phone.

Using Materials from the Internet

Fact check information you pull off the internet. Sources like trusted news magazines and newspapers (e.g., *The New York Times*, *The Economist*, etc.) usually don't publish until their facts have been checked and verified, but if you find information on John Doe's website, you should definitely research that data further. It's your duty to your reader and your company to report data correctly.

Don't take things off the internet and use them as your own. If you do not acquire written material, images or video someone else has posted to the internet in an appropriate manner, you are stealing—and stealing is unethical. Now, there is such a thing as "fair use," which makes it okay to use these materials for the purpose of "criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, or research…" If you fall into one of those categories, you're safe. Otherwise, your use of the material is considered a violation of copyright law. Look for the "creative commons" distinction on images and video to confirm that it's appropriate for shared use. We'll talk more about the use of visuals in Module 5: Visual Media.

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15.3: Introduction to Staying Connected

What you'll learn to do: Discuss the importance of staying connected with colleagues, other professionals and customers in the digital age

Now that we understand the tools and the processes by which we connect with other human beings—that is, the social communication model and the methods of communication—we can look at them in terms of this crazy, technological world we live in. Our coworkers, colleagues, and customers are out there waiting to communicate and be communicated with, and they're doing it in a variety of ways that are vastly different than they were twenty years ago.

More times than not, you don't even get to choose the tool you're using to communicate your message, so in this section, we're going to look at the ways you can digitally communicate with colleagues and customers, the strengths and weaknesses of those tools, and how to best leverage them to be understood.

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15.4: Staying Connected

Learning Objectives

- Discuss the importance of staying connected with colleagues and other professionals in the digital age
- Discuss the importance of staying connected with customers in the digital age

Connecting with Colleagues and Other Professionals

We live in a technological world, where teams of people can be collaborating and communicating from their respective offices, or even their couches and dining room tables, three thousand miles away from each other. And when you're working from your couch, without the opportunity to chat at the coffee machine or meet up for lunch, you're losing the opportunity to connect meaningfully with other people who have the same business interests, who can provide you with a set of amazing resources to help you succeed, and who look for your input and expertise to help them achieve their own goals.

Staying connected to people is more than just being able to do your job, it's about staying relevant and impactful and maintaining influence in your sphere—which can be hard to do from your dining room table. But conventional communication tools and approaches have been upended in favor of cutting edge digital alternatives that connect co-workers in these new and challenging circumstances. Let's look at some of these tools used to stay digitally connected with coworkers and other colleagues. We'll measure the methods of communication they aid and how well they facilitate the social communication model.

- **Document and work sharing tools:** Sharepoint and OneNote, both Microsoft products, are examples of tools that help you share work documents and collaborate on projects. Sharepoint allows you the ability to build a webpage for your department, house important and frequently used documents, and post basic, one-sided messages that are usually directly related to the content. OneNote performs a similar function but is more project oriented. The platform allows you to upload pictures and web links, create lists and to dos, and more. Neither of these projects allows for conversation, and they aren't meant to stand on their own as communication tools. In fact, because they're offered by Microsoft, usually other programs (like email) are integrated into them.
- **Private messaging and "chat" tools:** Private messaging and instant communication tools, like texting, require that the message be written. These tools allow for good, albeit sometimes slow, communication. The linear portion of communication (speaker–encoding–message–decoding–recipient) is easily facilitated in this method of communication, and "feedback" can be given, but "noise" is a frequent saboteur and not always easily identified. Why? Because non-verbal communication isn't present, tone of voice is not easily communicated, written messages can be misinterpreted as aggressive, angry and rude when they're not meant to be. Collaborative tools like Slack include a chat component into their platforms, but offer additional components that make communication more effective.
- **Video communication tools:**Skype, Google Hangouts,and Zoom, are examples of video communication tools that allow you to connect with people visually as well as aurally. Whether it's by chat room or simply dialing someone else with an account, you can have a decent conversation with coworkers as if they were in the room with you. The benefits are easy to see—not only is there the ability for verbal and listening communication, but nonverbal communication is apparent as well. Where a disembodied voice might agree to a decision, a video conference participant might send the non-verbal signal that she is not happy with the ending result. The visual bonus allows for heightened feedback in the social communication model, and the ability to clarify when noise exists. (See Module 9 for a lot more on video communication tools.)

You can communicate more effectively when you understand the strengths and pitfalls of these digital communication tools. Tools that facilitate multiple types of communication (verbal, listening, non-verbal) and allow the completion of the social communication model's circuit are more likely to aid you in getting your message across to your audience.

Connecting with Customers

Just as technology allows you to have a team of coworkers spread across the country or even the world, so does it allow for your customers to more easily access the products and services you offer. Staying connected with them is tantamount to staying connected with the team that helps you deliver those products and services.

Customers are looking for and using any of a number of methods of communication to interact with the brands, products and services they care about. In the age of social media, they're demanding conversation and human interaction. Digital communication tools can provide those avenues, but they also need to facilitate various methods of communication and complete the social communication model's circuit if they're going to be effective.

Let's take a look at what's out there.

- **Project and document sharing tools:** These tools exist to help support your side of the conversation. Tools like Microsoft's Delve allow you to pull up all your documents and information by contact. Have a meeting with the XYZ Widget Company? Delve allows you to access all of your recent documents, show you records of past conversations and so on. This digital tool supports your communication with a customer, but it doesn't take you past the "message" part on the social communication model. Still, they're handy tools to use when preparing to communicate.
- **Websites:** Almost every company has one to provide their customers with information about their products and services, as well as how to contact the company. Usually they feature information they're legally required to supply, like annual reports and financial filings. Your company's web design communicates your brand promise and personality, but a website on its own is a one-sided form of communication. It's the digital equivalent of "hanging out your shingle" and doesn't provide any opportunity for feedback from its viewers.
- **Blogging and Social Media:** This is a passive form of communication to your customers, one-sided and allowing for almost minimal feedback. That aside, blogging and social media allow you to communicate new products and information to your customers and establish that all-important "personality" customers are looking for in companies today.
- **Private message and "chat" tools:** Tools like Live Chat and Kayako have taken the customer service world by storm. When visiting a company's website, customers have come to expect that there will be some sort of chat option to talk with a customer service representative. These programs allow for canned conversational openings and encourage visitors to the website to have a discussion with a company representative where one might not have otherwise occurred. Nonverbal communication is nonexistent in this platform, so "noise" is almost a given, but feedback can be collected, closing the social communication model's circuit.
- **Video chat:** There's a short list of companies that are employing video chat tools to deal with customer service matters, and doing so with great success. It's the next best thing to a face to face conversation and provides the communicators access to all methods of communication. The social communication model is easily closed with feedback on noise, and active listeners can take non-verbal cues into consideration. The same holds true for this tool where more robust relationships with customers are the foundation of the business—lawyers, teachers, and therapists are among the many professionals who rely on careful face-to-face communication to perform their jobs effectively, and this type of communication can definitely facilitate that.

Digital communication tools can be effective, and the more methods of communication they allow, the better they can close the social communication model's circuit, the better they are. Choose your digital tool wisely and leverage its features so that you can most clearly, concisely, and objectively convey your message.

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15.5: Putting It Together- Communicating in Business

We've learned that there are seven principles by which you should evaluate any communication, be it verbal or written:

- Clear
- Concise
- Objective
- Consistent
- Complete
- Relevant
- Understanding of Audience Knowledge

If you adhere to these principles, you have a far better chance of being understood by your audience.

We've also learned about the social communication model. Through that, we learned that you create the message in your head and "encode it" into a message that can be understood, and then your audience "decodes" it to receive the message. In that process, there can be disruptive "noise" that distorts your message, but your audience can provide "feedback" that allows you additional chances to be understood.

We learned that there are types of communication—written, yes, but also spoken. And with spoken communication, verbal, listening and non-verbal communication are all taking place at the same time. Finding communication methods and tools that allow you to employ all three of those methods are the most efficient ways to good communication.

Finally, we considered ethical communication and how keeping these principles and laws of communication in mind can keep you on the straight and narrow path to ethical communication.

You're on your way to being a great communicator!

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15.6: Assignment- Communicating in Business

Part 1

Your task is to read the statements below and rate your perception of your communication skills.

- Download a PDF of this form here.
- Download a .docx file of this form here.

How often does this describe me during a conversation/communication?		Usually	Sometimes	Seldom
Writing Skills	I know the parts of a proper email, memo, and business letter formatting.			
	I know the basic parts of formal or informal reports.			
	I can evaluate a document to determine if it might be successful.			
Reading Skills	I am familiar with specialized vocabulary in my field of work.			
	I am willing to look up the meanings of words or concepts I don't fully understand.			
	I can get the basic meaning of words I am unfamiliar with by using context clues in the text			
	I am comfortable reading a text in a variety of mediums (paper, tablet, computer screen, etc)			
Listening Skills	I do not react to distractions (phone, etc).			
	I listen to half of the conversation without taking it over.			
	I can provide proper verbal and nonverbal feedback (nodding).			

How often does this describe me during a conversation/communication?		Usually	Sometimes	Seldom
	I can summarize the speaker's ideas by paraphrasing and asking questions.			
Speaking Skills	I find it easy and comfortable to talk with friends.			
	I find it easy and comfortable to talk with coworkers			
	I am confident when giving a presentation to different audiences			
	I am confident in pronouncing and using words correctly			

After rating your skills, write a short response to the following questions (max 500 words)

- What are your strongest and weakest skills?
- How do you think this class will help you improve or build upon your current communication skill set?

Part 2

Your task is to write an email to your instructor to introduce yourself. Put your first and last name and the assignment title in the subject line. For example: Maria Ruiz Assignment 1

Your message should address the following:

1. Reasons for taking this class
2. Your career goals (short term/long term)
3. Familiarity with computer technology
4. A brief discussion of how you view your current communication skill levels. Were there any parts of the quiz that surprised you? What are your strongest and weakest skills?
5. Is there anything in the class/syllabus that worries you? Any topic you are excited about or have extensive experience with?

Grading Rubric

Criteria	Not Evident	Developing	Proficient	Exemplary	Points

Criteria	Not Evident	Developing	Proficient	Exemplary	Points
Organization and format	**2 pts** Writing lacks logical organization. It may show some coherence but ideas lack unity. Serious errors and generally is an unorganized format and information.	**3 pts** Writing is coherent and logically organized, using a format suitable for the material presented. Some points may be contextually misplaced and/or stray from the topic. Transitions may be evident but not used throughout the essay. Organization and format used may detract from understanding the material presented.	**4 pts** Writing is coherent and logically organized, using a format suitable for the material presented. Transitions between ideas and paragraphs create coherence. Overall unity of ideas is supported by the format and organization of the material presented.	**5 pts** Writing shows high degree of attention to details and presentation of points. Format used enhances understanding of material presented. Unity clearly leads the reader to the writer's conclusion and the format and information could be used independently.	**5 pts**
Content	**2 pts** Some but not all required questions are addressed. Content and/or terminology is not properly used or referenced. Little or no original thought is present in the writing. Concepts presented are merely restated from the source, or ideas presented do not follow the logic and reasoning presented throughout the writing.	**3 pts** All required questions are addressed but may not be addressed with thoughtful consideration and/or may not reflect proper use of content terminology or additional original thought. Additional concepts may not be present and/or may not be properly cited sources.	**4 pts** All required questions are addressed with thoughtful consideration reflecting both proper use of content terminology and additional original thought. Some additional concepts may be presented from other properly cited sources, or originated by the author following logic and reasoning they've clearly presented throughout the writing.	**5 pts** All required questions are addressed with thoughtful in-depth consideration reflecting both proper use of content terminology and additional original thought. Additional concepts are clearly presented from properly cited sources, or originated by the author following logic and reasoning they've clearly presented throughout the writing.	**5 pts**

Criteria	Not Evident	Developing	Proficient	Exemplary	Points
Development – Critical Thinking	**4 pts** Shows some thinking and reasoning but most ideas are underdeveloped, unoriginal, and/or do not address the questions asked. Conclusions drawn may be unsupported, illogical or merely the author's opinion with no supporting evidence presented.	**6 pts** Content indicates thinking and reasoning applied with original thought on a few ideas, but may repeat information provided and/ or does not address all of the questions asked. The author presents no original ideas, or ideas do not follow clear logic and reasoning. The evidence presented may not support conclusions drawn.	**8 pts** Content indicates original thinking, cohesive conclusions, and developed ideas with sufficient and firm evidence. Clearly addresses all of the questions or requirements asked. The evidence presented supports conclusions drawn.	**10 pts** Content indicates synthesis of ideas, in-depth analysis and evidence beyond the questions or requirements asked. Original thought supports the topic, and is clearly a well-constructed response to the questions asked. The evidence presented makes a compelling case for any conclusions drawn.	**10 pts**
Grammar, Mechanics, Style	**2 pts** Writing contains many spelling, punctuation, and grammatical errors, making it difficult for the reader to follow ideas clearly. There may be sentence fragments and run-ons. The style of writing, tone, and use of rhetorical devices disrupts the content. Additional information may be presented but in an unsuitable style, detracting from its understanding.	**3 pts** Some spelling, punctuation, and grammatical errors are present, interrupting the reader from following the ideas presented clearly. There may be sentence fragments and run-ons. The style of writing, tone, and use of rhetorical devices may detract from the content. Additional information may be presented, but in a style of writing that does not support understanding of the content.	**4 pts** Writing is free of most spelling, punctuation, and grammatical errors, allowing the reader to follow ideas clearly. There are no sentence fragments and run-ons. The style of writing, tone, and use of rhetorical devices enhance the content. Additional information is presented in a cohesive style that supports understanding of the content.	**5 pts** Writing is free of all spelling, punctuation, and grammatical errors and written in a style that enhances the reader's ability to follow ideas clearly. There are no sentence fragments and run-ons. The style of writing, tone, and use of rhetorical devices enhance the content. Additional information is presented to encourage and enhance understanding of the content.	**5 pts**
				Total:	**25 pts**

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15.7: Assignment- Seven Pillars of Communication

Open Pedagogy Assignments are assignments in which students use their agency and creativity to create knowledge artifacts that can support their own learning, their classmates' learning, and the learning of students around the world. (See this peer-reviewed article for more details.) The assignment on this page is aligned to a learning outcomes of Business Communication for Managers and we've identified the module where the reading appears. All of the assignments can be created with a cell phone camera or any video recording device, Google or Word documents, and your learning management system.

Learning Outcome

- Identify key features of effective writing in business

In the first module of the course, we introduce effective communication in a business setting. For this assignment, you are going to create a short video of less than two minutes about your experience with a business either as an employee or as a customer. Think about a time when you had a positive experience with communicating your perspective in a business setting.

It's one thing to read about the experiences of other people and it's quite another experience to see and listen to people's stories. For this assignment, let's use informal stories about your positive experiences to share what works for managers.

Using your cell phone or any other recording device, create a short video for this assignment. You don't have to edit or create a professional-grade film. You've most likely have done this type of recording already on social media, so feel free to use the same informal conversational tone.

Think of your audience as other students who are eager to improve their communication skills in a business setting. In your video, you'll want to practice using the concepts (in bold listed below) of the seven pillars of business communication.

If you need some questions to guide your response, here is a short list.

The seven pillars of communication have the following elements:

1. What was **clear** about the communication in your experience?
2. What were the **concise** details of the exchange?
3. What **objective** details can you give your audience about the event?
4. How were the speakers **consistent** in their messaging?
5. What left you feeling **complete** about the exchange?
6. What were the **relevant** details?
7. How did the company demonstrate **an understanding of audience knowledge?**

A Note To Teachers: Your students in the first term will create videos, and with their permission you can upload them into your course in order to show examples for the next term. The idea will be to have students generate content that other students can listen to and learn from with this assignment. Encourage them to use positive and negative examples from their work experience or from their experience as customers.

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15.8: Why It Matters- Communicating in Business

Why learn to effectively communicate in business?

Business is about people. We exist to serve people with our products and services, to employ them and pay them to do work, to purchase the supplies and merchandise we need to operate. To be in business is to be surrounded by people who interact with you, who require something from you.

Communication is the connection between people. It could be a shared photograph, a letter or a smoke signal, but as long as one person is sending a message and another person is understanding it, communication is happening.

The successful professional builds and maintains relationships, completes tasks, directs teams, and expresses ideas via effective communication. To be successful you'll need to be an effective communicator: you need to be understood.

Playwright George Bernard Shaw is quoted as saying, "The single biggest problem in communication is the illusion that it has taken place." This module is the first step in dispelling the illusion. Here we will talk about the elements of communication—recognizing the pattern of good communication, the types of communication you're likely to see in the workplace, and the kinds of tools you can use to effectively build your message, deliver it, and be understood by your audience.

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15.9: Introduction to Effective Communication in Business

What you'll learn to do: Discuss the importance of effective communication in business

Communication happens when all parties are engaged in uncovering and understanding the meaning behind the words. It's not something that one person does alone. But when you, as a business professional, make your contribution to the uncovering and understanding process, you should strive to be:

- Clear
- Concise
- Objective
- Consistent
- Complete
- Relevant
- Understanding of Audience Knowledge

These are the seven pillars, or principles, of business communication. If you open your mouth, put pen to paper, or pick up a camera to make a video, you should be striving to create a message that meets these criteria.

Why? Well, the point of communication is not to talk. It's to be understood. When your team understands you, they deliver results. When your customers understand you, they buy. When your manager understands you, she advocates for you and supports you in your career.

This module will talk about the benefits of effective business communication and how, using the principles above, you can improve your communication skills and be more successful in business.

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15.10: Becoming a Better Employee

Learning Objectives

Discuss how effective communication improves you as an employee

Communication is something we often take for granted but not often something we think to improve. And yet, being a good communicator can open doors for you as an employee, make you more valuable to your employer and help you get ahead.

Think about the tree swing in Figure 1. The creation of that swing started out all wrong and then got worse from there.

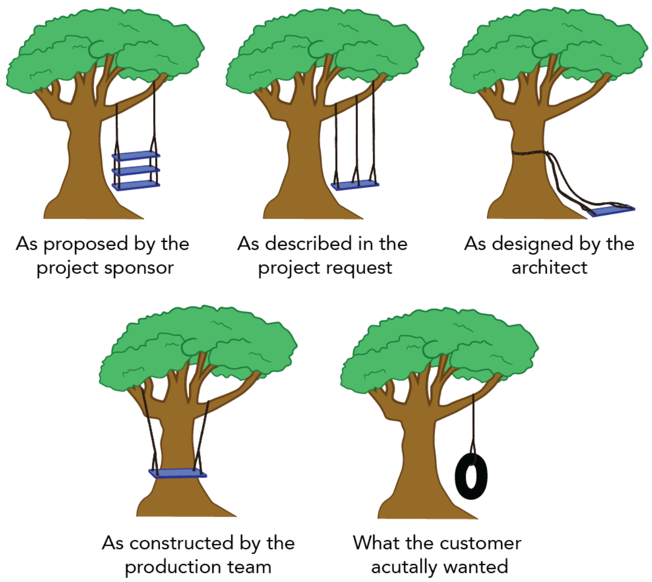


Figure 1. This common example of a tree swing shows just how things can go wrong as you create a new product or service. (CC BY; Lumen Learning)

Let's approach that process as though you were in charge. How could you have been a better employee and improved that result with better communication? We'll look at it step by step.

1. **Meeting with the project sponsor:** As the sales associate of this tree swing, you met with the project sponsor, Mark, and heard his translation of the customer's wishes. Mark very clearly told you he wanted a swing with three seats, one on top of another. Now, you're an expert on tree swings. Does his request make sense? This is an effective communication opportunity. You could have asked questions, clarified and repeated back what Mark was telling you. You could have told him that this kind of swing design was highly unusual and not generally embraced by tree swing aficionados. An opportunity to engage in effective communication with the customer was missed.
2. **Specifying the project request:** This is where you, as swing sales person, made your first mistake. Rather than requesting three seats, you requested three ropes to secure the swing to the tree. This is another effective communication opportunity. You could have proofread and double-checked to make sure your request matched Mark's request, but you did not. An opportunity to ensure effective communication via reinforcement and repetition was missed.
3. **Designing, production and installation:** Here's where the project went from wrong to wrong-er. Your swing production team not only didn't question your request for three ropes, they went off and did their own thing with the concept and design of the product. The architect misunderstood your request completely. The production team reviewed the architect's request and knew his design wasn't functional, and so made their own changes. Finally, the installation team got there and the product wouldn't work without additional reinforcements, so they did what was needed to make the product functional. This is another effective communication opportunity Not only did they miss opportunities to communicate with each other, but you missed an opportunity for follow-up, reinforcement and repetition.

Your manager, Gloria, is going to get calls from customers, and when she's done hearing their complaints, is she going to think you're employee of the year? Probably not. You didn't deliver good results.

Employees who communicate effectively by listening, repeating, reinforcing and following up avoid all these issues. They are presented with a problem, they take in all the necessary information, and then they direct their teams with messaging that is

- Clear
- Concise
- Objective
- Consistent
- Complete
- Relevant
- Considerate of the knowledge his audience possesses

Because of better communication, they become better team members, co-workers, and employees.

15.11: The Business Audience

Learning Objectives

- Identify characteristics of your audience in business communication
- Discuss the process of the social communication model

As a business communicator, you'll be communicating to two types of audiences.

- Your **primary audience** is the audience that your communication is intended for. For instance, if you're preparing an earnings report, the audience is likely your senior team. They will review the information, give you feedback, and decide if they need to take action based on the information you've provided.
- Your **secondary audience** is the group of people that aren't real stakeholders in your communication. That same earnings report, with the senior team as its primary audience, might find other audiences in investors, stockholders, or even your competitors or the media. They may comment on your data or take action on it.

Why is it important to understand primary and secondary audiences and what the differences are between them? Consider the following points:

- **Managing information:** When you consider the information you should be communicating, you need to consider the needs of your primary audience first. The information they require to do their work is your first concern. Any information that would be important to a secondary audience should be relegated to a less prominent area of the report.
- **Managing language:** A key factor in communicating effectively is the assessment of the knowledge that your intended audience brings to the table. If your primary audience is a bunch of school kids and your challenge is to explain key economic factors in the 1929 stock market collapse, your language will be much different than if you explain it to a group of historians. Choose the correct language to communicate.
- **Managing the depth of your topic:** The human resources team might want to dig into a turnover report in great detail and, if they're your primary audience, it's your job to communicate that information to them. On the other hand, the CEO may just want to know what the annualized rate is. "Are people staying or are they leaving?" he will ask. Sometimes a simple, "Staying," is all he needs to know.

You will communicate more effectively if you understand your audience and the depth of knowledge they bring with them to the communication event.

The Social Communication Model

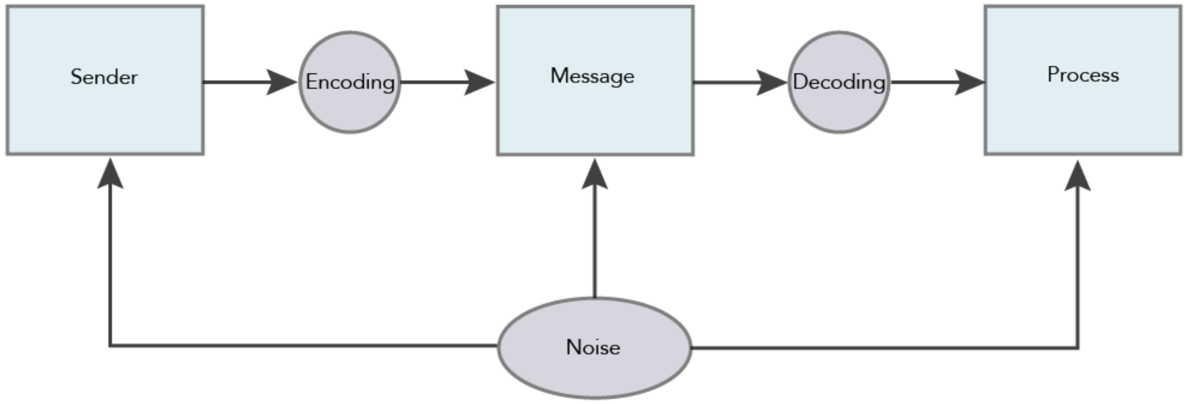
Communication suggests a linear process. There's a sender of a message—let's say that's you talking. You put your thoughts into words. And then there's a recipient of a message. He hears those words and considers their meaning. That's your co-worker, listening. It looks something like this:

You, the sender, have a thought. You put that thought into words (encoding). The message comes out of your mouth, and then it is decoded (processed) by the recipient, your co-worker, who then decides on the meaning of your words as a result of that decoding process.

But what you say isn't always what your co-worker hears. And that's where things go wrong.

Let's pretend that you're listening to some music, a good Jimi Hendrix tune. And you sing along with the lyric, "Excuse me while I kiss the sky": *Purple Haze*—classic Jimi Hendrix.

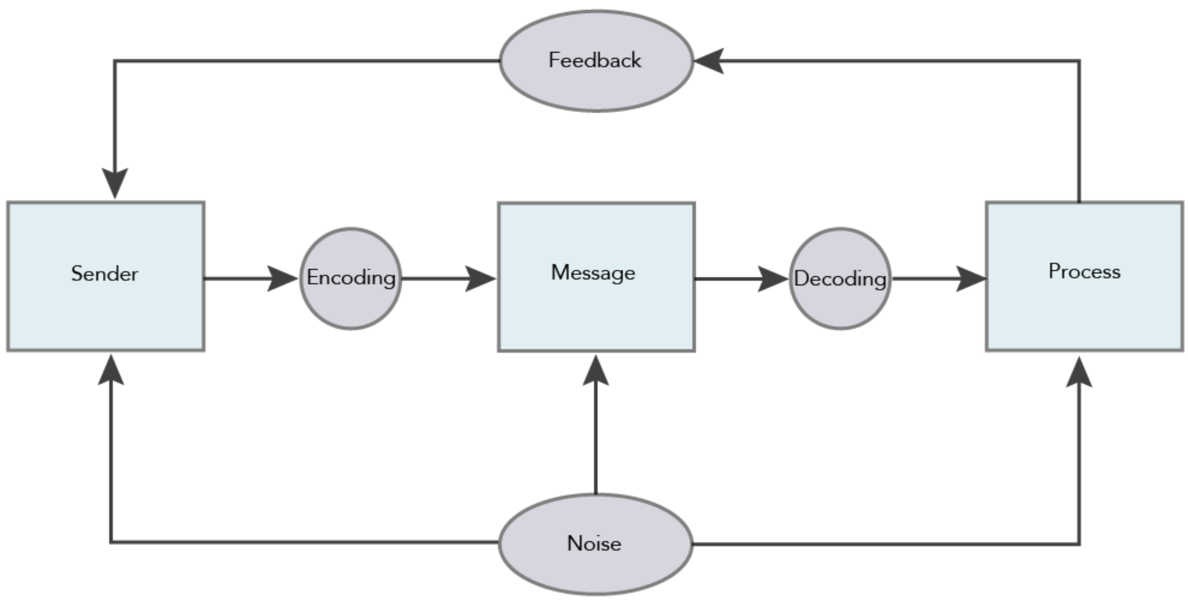
So, you're inspired by the music and sing the words in much the same way Jimi sings it. You think it, you put it into words (encoding it), and it becomes a message. Is everything good? Maybe not. It's possible that Jimi's "stylized" approach to singing lyrics is going to get in the way of your message. This is called noise.



The noise disturbing your message can jump in at any time. It can be actual noise, it can be a concept misunderstood by the sender before the message is even formed, it can be a message that's not articulated properly, or it can be a message that's just not understood by the receiver. In this case, the "noise" is you imitating the way Jimi sings his lyric, which is not spoken all that clearly.

Your co-worker hears your communication, and the message you encoded and sent to him is not decoded in the same way, because the decoding process is affected by "noise." As a result, your coworker thinks you've said, "Excuse me while I kiss this guy."

He frowns and tells you, "You probably shouldn't be kissing anyone at work." This is called feedback.



Your recipient has let you know that you've been misunderstood by giving you feedback. At this point you can:

- Repeat the message a second time
- Ask some clarifying questions to determine why your recipient didn't understand what you said and then address those issues on your next attempt to communicate your idea.

In this case, you immediately realize how you've been misunderstood. This happens all the time when people hear this song. You process the feedback and encode a new message. You tell him, "No. It's 'Excuse me while I kiss *the sky*.' Not 'Excuse me while I kiss this guy.'"

When the communication is only linear, extending from sender to recipient, you're talking *at* your audience. The minute there's feedback from the audience, like with the social communication model, you're talking *with* your audience. Talking with an audience ensures a better level of understanding.

Effective communication means leveraging the social communication model to make sure your team is all singing the same song.

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15.12: Writing in Business

Learning Objectives

- Identify key features of effective writing in business
- Discuss the overlap between professional and personal communication

Just like having a face-to-face discussion, effective business writing should rely on the seven principles of business communication:

- Clear
- Concise
- Objective
- Consistent
- Complete
- Relevant
- Considerate of Audience Knowledge

When you put pen to paper, you should be considering every principle. We've looked at these principles before, but now let's take a deep dive into how they might impact your writing.

Phone System Outage

Let's assume that you're writing a communication to let everyone know that the corporate office phone system will be down for a certain period of time next Friday morning. Let's take a look at how each of the principles of business communication figure into that written message.

- **Clear:** When you craft the message, you should make sure that it's clear to your readers. In this case, you want the entire company to know that the corporate office phone systems will be down between 9 and noon. Being clear means that you add *a.m.* and *p.m.*, even if you think it might be obvious. You should indicate that you're talking about Pacific Standard Time, and so on.
- **Concise:** Since it's a message about the phone system, it should be a message only about the phone system. And then, a message only about the outage. If you're inspired to include, "Tom broke the phone system last week and now it needs to be repaired," resist this urge. Even if Tom is responsible for the outage, it may be appropriate to joke with Tom about it if he's a personal friend, but this is not the kind of messaging that should go out to the whole office.
- **Objective:** Your own personal feelings and comments do not need to be a part of the phone communication. For instance, "Even though the timing is poor for those working on the polling project, we intend to repair our phone system on Friday" is a great example of *not* being objective.
- **Consistent:** If the phone system has been out three or four times before, your message should be similar in nature to those that came before it. If one of the details of the phone system is that it's being upgraded so we can add a new satellite office to the trunk line, don't include information contrary to this fact unless it is explained. Consistent means that the details are the same each time–that the communication looks the same, sounds the same; and that any new details are called out.
- **Complete:** If you set out to tell the company that the phone system is going to be out at 9:00 a.m. on Friday morning and then fail to tell them when it will be back up, then your message is incomplete. Strive to be complete in your written communication by anticipating any question a reader might ask: "Is the phone system going down this Friday or next Friday?" "How long will it be down?" "Is the whole corporate office affected or just a portion?"
- **Relevant:** When considering whether a message is relevant, you can ask yourself, "Are these readers affected by this information?" "Does it matter that the phones will be out on Friday if the office is closed for the holiday?" It also means not including information that isn't relevant to the reader, such as, "The repair people think that, by replacing the left widget on the main switchboard, they may solve the problem, but it could also be the right widget, in which case they'll need to order a part." This is *not* relevant.
- **Considerate of Audience Knowledge:** Always keep in mind the knowledge your audience brings to the message. If you're communicating the details of nuclear fission to a group, you would talk to them differently depending on how much they knew about science. In this case, everyone understands what a phone is. (Though those two extraterrestrials just hired in real estate may need to know it's the black thing on their desk with the handset you can put up to your ear.)

It’s incredibly important to measure your written communication against the seven principles of business communication because in written communication, the “feedback” portion of that social communication model isn’t always accessible. When noise enters your written communication, you often don’t immediately know that your audience doesn’t understand, sometimes until it’s too late. Make sure you measure your message against the seven principles to stay ahead of any misunderstandings.

Personal and Professional Communication

When you consider the difference between communication on a personal level and communication on a professional level, the first thing that comes to mind is the level of formality. In personal communication, you typically use relaxed language, and the level of knowledge your audience brings into the communication is usually significant and personal. The need to be clear and concise, to be objective, is thrown aside. Personal communications are often meant only for a single audience and are oftentimes understandable only to that audience.

Professional communication, on the other hand, is read by an audience that you don’t know as well. You find you need to make an effort to be clear, concise, relevant and objective. You make an effort to appeal to and be understood by a more diverse group.

However, with the advent of technology and social media, the lines between personal and professional communication are becoming blurred. Your customers are looking to connect with your company on a deeper, more personal level. Technology has turned the 9–5 worker into an always-accessible team member, and because of it, professional relationships are evolving into something that straddles the line between formal and informal. Customers, vendors, and even co-workers want to deal with a human being, not someone hiding behind the curtain and operating the great and powerful talking head that runs the company. Add to that myriad methods of informal communication platforms like texting and social media, and you can see there’s a revolution going on here.

Your business communications are destined to be affected by this shifting tide. If companies with strong brands are going out of their way to connect with their customers on social media and share the “human side” of their businesses, then there’s no reason why you shouldn’t follow suit as long as you feel comfortable doing so.

Some things to keep in mind if you’re going to give it a try:

- **Don’t give up the seven principles of business communication:** No matter how personal you get, those principles are still the hallmark of a successful message. Your wider audience still needs clarity, uniformity, and so on. Your goal is to be understood, to yield a particular business result, and that doesn’t change.
- **Don’t get personal to the point of irrelevance:** Your co-workers and vendors might enjoy knowing that you’re a huge football fan, but they don’t need to know what you had for lunch today.
- **Don’t share details that might not be easily embraced:** People don’t always receive the message well if you express strong political beliefs that don’t fit with theirs. Be careful about sharing your “ideals.” GoDaddy.com CEO Bob Parsons got called out in 2011 when he made a video of his exploits hunting elephants and posted it to his company’s site so he could “share” himself with the world. The attention he got for his moment of personal sharing wasn’t good.

Even though professional communication and personal communication are quickly becoming just “communication,” your success still hinges on being successful at it. Strengthen your command of the seven communication principles and move forward bravely with your list of shareable personality traits.

15.13: Introduction to Methods of Communication

What you'll learn to do: Differentiate between different methods of communication

Words are just the beginning of communication and, to hear people tell it, they're actually a very small part of the message we take in. Don't believe it? Imagine you're hanging out with your teenage cousin, and you ask him if he's feeling happy today. He might respond, "Yeah, sure." But depending on the tone of his voice and his body language, you might not believe him.

Listening and nonverbal cues affect communication as much as the written or spoken word. In this section, we're going to learn how to use listening, verbal communication, and nonverbal communication to your advantage, so you can better understand and be better understood.

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15.14: Listening

Learning Objectives

- Discuss the importance of listening

Figure 1. Listening is a key component of communication.

How many times have you wanted to talk about a subject very important to you only to find that the people you're talking to aren't really listening? They may look like they're listening, but they're really not paying attention at all. Frustrating, isn't it? How often do you find yourself falling into this same trap, finding that you're so eager to share your information that you completely stop listening to the person who's talking?

Communication isn't just about talking, it's about listening. In fact, communication only happens when all parties are engaged in uncovering and understanding the meaning behind the words. Otherwise, it's just a bunch of chatter!

Active Listening

During active listening, listeners give feedback to the speaker, confirming an understanding of what the speaker has said by asking questions and making clarifying statements. Rather than focusing on what they want to say once it's their turn to speak or allowing themselves to be distracted, they're reassuring the speaker that they're interested in the subject matter and want to completely understand the point the speaker is trying to make. It's the ultimate way of making a fellow participant feel safe in the conversation.

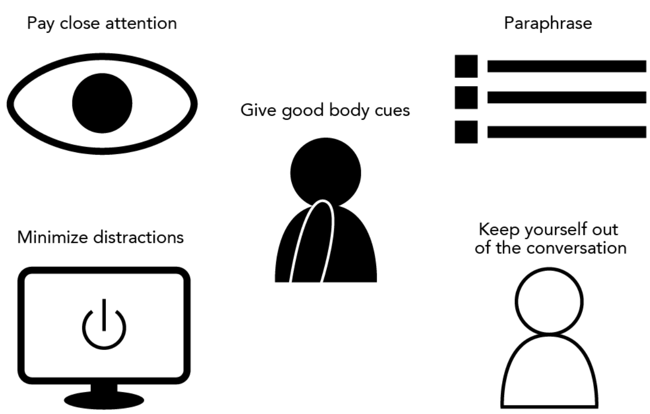

Figure 2. Five key skills for active listening

Here are some key skills you should master in order to be an active listener:

1. **Pay close attention and paraphrase to ensure understanding:** If you can step into the conversation by saying, "So let me see if I understand this correctly. What you're saying is…." then you're listening hard enough. If you're saying, "Uh-huh, uh-huh," but not really recapping a set of statements, then try listening a little harder.
2. **Ask open ended questions:** These questions can encourage the speaker to elaborate on a point, rather than forcing them to say yes or no. This elaboration can also help you understand better what the speaker is trying to communicate.
3. **Give good body cues:** Make eye contact, lean in while the speaker is talking, and don't let your gaze drift away. If you're leaning back in a chair reading what's on your computer monitor, the speaker isn't going to feel like you're paying attention even if you are. You can also use body cues to reflect the speaker's emotions—you don't have to laugh or cry along, but you can indicate a level of understanding with a facial expression or a nod.

4. **Minimize distractions:** Turn off your radio or push your monitor in another direction in order to pay closer attention to what your guest has to say. When someone is talking to you, do your best to minimize anything that could steal your attention away from the conversation.
5. **Keep yourself out of the conversation:** Avoid sharing how you handled a similar issue, unless you're specifically asked for advice. Keep an open mind about the subject matter, even if you don't agree. If someone is complaining about your previous behavior or choices, wait until he or she is done before you launch into a defense. Better yet, don't launch into a defense. Instead, ask clarifying questions and make sure that you totally understand the other person's point of view before crafting your response.

Those are just a few techniques you can use to become a better listener, but there are also a few ways to ensure that you're heard. Take those same hints for active listening and turn them around a bit:

- **Help your audience by paraphrasing:** If no one in your audience is being kind enough to break in to clarify his understanding of your point, then do it for them! Pause mid-point and say, "Let me stop here for a moment. Am I being clear about what I'm trying to say? Is there anything up to this point that you'd like me to go over again?" By posing these questions, you're encouraging your audience to participate in active listening.
- **Minimize things that could be distracting during your conversation:** Don't be afraid to ask your audience to turn off the television for a moment while you make an important point.
- **Keep your audience out of the conversation:** In much the same way you kept yourself out of the conversation when someone else was talking, don't invite them to share their own personal stories. It distracts from the point you're trying to make.

Without listening, there is no understanding. By listening, you can assess your audience's needs and address them. By ensuring that you're heard, you can deliver business results.

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15.15: Verbal and Nonverbal Communication

Learning Objectives

- Discuss verbal communication and its role in business
- Discuss nonverbal communication and its role in business

Verbal Communication

Verbal communication is perhaps the most obvious and understood mode of communication, and it is certainly a powerful tool in your communication toolbox. Put simply, verbal communication is the sharing of information between two individuals using words.

Spoken versus Written Communication

While we typically focus on speech while talking about verbal communication, it's important to remember that writing is also a form of verbal communication. After all, writing uses words too!

Imagine for a moment that you're a college student who is struggling with material in a class. Rather than simply giving up, you decide that you're going to ask your instructor for the guidance you need to make it through the end of the semester. Now, you have a few choices for using verbal communication to do this. You might choose to call your instructor, if they've provided contact information, or talk to them in person after class or during office hours. You may take a different approach and send them an email. You can probably identify your own list of pros and cons for each of these approaches. But really, what's the difference between writing and talking in these situations? Let's look at four of the major differences between the two:

1. **Formal versus Informal:** We generally use spoken communication informally while we use written communication formally.
2. **Synchronous versus Asynchronous:** Synchronous communication is communication that takes place in real time, such as a conversation with a friend. In contrast, asynchronous communication is communication that is not immediate and occurs over longer periods of time, such as letters, email, or even text messages.
3. **Recorded versus Unrecorded:** Written communication is generally archived and recorded for later retrieval while spoken communication is generally not recorded.

Benefits of Spoken Communication

Spoken communication can be a conversation, a meeting, or even a speech. Spoken communication is powerful in that it allows for input from every part of the social communication model. You encode your thoughts into the spoken word and look to your audience to decode and take the message in. You can ask for feedback directly to confirm understanding of your message.

In a world where we do most of our talking by email and text, spoken communication is a breath of fresh air. Leverage the power of spoken communication to create relationships—you can establish a rapport and a sense of trust with your audience when you speak with them. Spoken communication allows you to bond on a more emotional level with your listeners.

Spoken communication also also makes it easier to ensure understanding by addressing objections and clearing up misunderstandings: you can adjust your message as you communicate it, based on the feedback you're getting from your audience. Spoken communication allows you to walk away from a conversation with a higher degree of certainty that your message was received.

Verbal communication is a powerful tool, and it's made even more powerful when paired with listening and nonverbal communication.

Nonverbal Communication

We've already employed a little bit of nonverbal communication with the active listening skills we've previously discussed: nodding, facial expressions, leaning toward the speaker to show interest—all of those are forms of nonverbal communication. Body language can reinforce your spoken message or it can contradict it entirely.

There's a myth that says that when you speak, only 35 percent of your communication is verbal and 65 percent of it is nonverbal. That's not entirely true (or else foreign languages would be much easier to understand!). But it's absolutely true that nonverbal communication can make or break your message. Here are some types of nonverbal communication and the effects they can have on the success of your communication:

- **Facial expressions:** Your teenage cousin we referred to at the beginning of this section might have told you he was happy, but his apathetic facial expression may have communicated different information. Facial expressions—happy, sad, angry—help you convey your message. Be aware of your facial expression when you talk and particularly when you listen, which is when it's easy to forget.
- **Gestures:** When you speak, a gesture can make your message stronger. Pointing out something you want your listener to look at more closely is an example of nonverbal communication that makes your message understood. Motioning warmly toward a coworker who deserves special recognition, making a fist to show frustration or anger, such gestures help further engage your audience when you speak.
- **Proximity:** How close you are to your audience when you speak sends a nonverbal message. If your size is imposing and you leave a very small distance between you and your listener, it's likely your nonverbal communication will be a bit threatening. On the other hand, giving someone too much space is an awkward nonverbal communication that might confuse your listener.
- **Touch:** Shaking an audience member's hand, putting your hand on his shoulder: these are nonverbal cues that can affect the success of your message. Touch communicates affection, but it also communicates power. In fact, when women touch a listener, it's often assumed that they're being affectionate or conveying empathy, but when a man touches a listener, it can be taken as a sign of communicating power or even dominance.
- **Eye contact:** Making and maintaining eye contact with an audience when you're verbally communicating or listening communicates to the other party that you're interested and engaged in the conversation. Good eye contact often conveys the trait of honesty to the other party.
- **Appearance:** Your clothing, hair, and jewelry are also a part of nonverbal communication. If you put a dachshund pin on your lapel each morning (because you have a pet dachshund), that says something about you as a person. Similarly, the quality and condition of your clothing, how it fits, if it's appropriate for the season—all of these things speak nonverbally about you as a communicator.

Nonverbal communication reveals a lot about you as a communicator and how you relate to other people. It pays to be aware of the elements of your nonverbal communication so you can maximize the impact of your message.

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15.16: Introduction to Ethics in Business Communication

What you'll learn to do: Discuss the importance of ethical communication

As business practices become more transparent and the people behind those businesses become more public, customers and patrons begin to expect more from these businesses. It's no longer a faceless corporation trudging along making a profit and paying their investors. Because of this, in order to be successful in today's environment, a company has to be socially conscious and to behave ethically.

That's a trend whose thread is woven into every aspect of business, and that's not a bad thing. Communicators should absolutely be cultivating a level of trust and integrity in each of their messages. They should be socially conscious and inclusive in their communications. It's what audiences expect and, frankly, what they should have.

In this module we'll take a look at the guidelines for ethical communication and how they apply to verbal, written and online communications.

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CHAPTER OVERVIEW

16: Business and Technology

16.1: Data versus Information
16.2: Managing Data
16.3: Types of Information Systems
16.4: Computer Networks and Cloud Computing
16.5: Data Communications Networks
16.6: Security Issues in Electronic Communication
16.7: Careers in Information Management
16.8: Cases and Problems

16.1: Data versus Information

Learning Objectives

1. Distinguish between data and information.
2. Define information system (IS) and identify the tasks of the information systems manager.

By the time the company took the plunge and committed $100 million to marketing-related information technology (IT), Caesars had been collecting and storing data about customers for almost a decade. “While the company thought it important to collect customer information,” recalls a senior marketing executive, “the problem was we had millions of customers to collect information on, but we had no systematic way of turning it into a marketing decision. We didn’t know what to do with it.” In other words, Caesars was collecting a lot of *data* but not necessarily any *information*. So what’s the difference?

As an example, suppose that you want to know how you’re doing in a particular course. So far, you’ve taken two 20-question multiple-choice tests. On the first, you got questions 8, 11, and 14 wrong; on the second, you did worse, missing items 7, 15, 16, and 19. The items that you got wrong are merely data—unprocessed facts. What’s important is your total score. You scored 85 on the first exam and 80 on the second. These two numbers constitute information—data that have been processed, or turned into some useful form. Knowing the questions that you missed simply supplied you with some data for calculating your scores.

Now let’s fast-forward to the end of the semester. At this point, in addition to taking the two tests, you’ve written two papers and taken a final. You got a 90 and 95 on the papers and a 90 on the final. You now have more processed data, but you still want to organize them into more useful information. What you want to know is your average grade for the semester. To get the information you want, you need yet more data—namely, the weight assigned to each graded item. Fortunately, you’ve known from day one that each test counts 20 percent, each paper 10 percent, and the final exam 40 percent. A little math reveals an average grade of 87.

Though this is the information you’re interested in, it may be mere data to your instructor, who may want different information: an instructor who intends to scale grades, for example, will want to know the average grade for the entire class. You’re hoping that the class average is low enough to push your average of 87 up from a B+ to an A– (or maybe even an A—it doesn’t hurt to hope for the best). The moral of the story is that what constitutes *information* at one stage can easily become *data* at another: or, one person’s information can be another person’s data.

As a rule, you want information; data are good only for generating the information. So, how do you convert data into information that’s useful in helping you make decisions and solve problems? That’s the question we’ll explore in the next section.

16.2: Managing Data

> **Learning Objective**
> 1. Explain how IS managers capture, store, and analyze data.

Did you ever think about how much data you yourself generate? Just remember what you went through to start college. First, you had to fill out application forms asking you about test scores, high school grades, extracurricular activities, and finances, plus demographic data about you and your family. Once you'd picked a college, you had to supply data on your housing preferences, the curriculum you wanted to follow, and the party who'd be responsible for paying your tuition. When you registered for classes, you gave more data to the registrar's office. When you arrived on campus, you gave out still more data to have your ID picture taken, to get your computer and phone hooked up, to open a bookstore account, and to buy an on-campus food-charge card. Once you started classes, data generation continued on a daily basis: your food card and bookstore account, for example, tracked your various purchases, and your ID tracked your coming and going all over campus. And you generated grades.

And all these data apply to just one aspect of your life. You also generated data every time you used your credit card and your cell phone. Who uses all these data? How are they collected, stored, analyzed, and distributed in organizations that have various reasons for keeping track of you?

16.3: Types of Information Systems

Learning Objective

1. Discuss ways in which an IS can be designed to meet the needs of individuals at various organizational levels.

As we saw earlier, different managers, operational units, and functional areas have different information needs. That's why organizations often tailor information systems to meet particular needs. Caesars's IT group, for example, developed the Player Contact System (Dunn, 2003; Dunn, 2003). to help its casino salespeople connect to top customers on a more personal basis. Working from a prioritized list of customer names displayed on a computer screen, the salesperson clicks on a name to view relevant information about the customer, such as background and preferred casino activities. There's even a printed script that can be used to guide the conversation. Such a system isn't very helpful, however, to middle or top-level managers, who need systems to help them carry out their oversight and planning responsibilities. To design marketing programs, for instance, marketing managers rely on summary information gleaned from a dedicated customer-relationship management system. Let's look at some of the widely available information systems designed to support people at the operational and upper-management levels.

16.4: Computer Networks and Cloud Computing

Learning Objectives

1. Describe the main systems for sharing information through networked computers.
2. Define cloud computing and identify its advantages and disadvantages.

Once it's grown beyond just a handful of employees, an organization needs a way of sharing information. Imagine a flower shop with twenty employees. The person who takes phone orders needs access to the store's customer list, as do the delivery person and the bookkeeper. Now, the store may have one computer and everyone could share it. It's more likely, however, that there are a number of computers (several for salespeople, one for delivery, and one for bookkeeping). In this case, everyone needs to be sure that customer records have been updated on all computers every time that a change is required.

16.5: Data Communications Networks

Learning Objective

1. Explain how four networking technologies—the Internet, the World Wide Web, intranets, and extranets—make data communication possible.

In addition to using networks for information sharing within the organization, companies use networks to communicate and share information with those outside the organization. All this is made possible by data communication networks, which transmit digital data (numeric data, text, graphics, photos, video, and voice) from one computer to another using a variety of wired and wireless communication channels. Let's take a closer look at the networking technologies that make possible all this electronic communication—in particular, the *Internet* (including the *World Wide Web*), *intranets*, and *extranets*.

16.6: Security Issues in Electronic Communication

Learning Objective

1. Identify and discuss challenges faced by companies engaged in e-commerce.

E-commerce has presented businesses with opportunities undreamt of only a couple of decades ago. But it also has introduced some unprecedented challenges. For one thing, companies must now earmark more than 5 percent of their annual IT budgets for protecting themselves against disrupted operations and theft due to computer crime and sabotage (Alexander, 2011). The costs resulting from cyber crimes—criminal activity done using computers or the Internet—are substantial and increasing at an alarming rate. A 2010 study of forty-five large U.S. companies revealed that the median cost of cybercrime for the companies in the study was $3.8 million a year (Ponemon, 2010). And some cybercrimes involve viruses that can spread rapidly from computer to computer creating enormous damage. It's estimated, for example, that damage to 50,000 personal computers and corporate networks from the so-called Blaster worm in August 2003 totaled $2 billion, including $1.2 billion paid by Microsoft to correct the problem (Shukovsky, 2011). The battle against technology crime is near the top of the FBI's list of priorities, behind only the war against terrorism and espionage (Alexander, 2011). In addition to protecting their own operations from computer crime, companies engaged in e-commerce must clear another hurdle: they must convince consumers that it's safe to buy things over the Internet—that credit-card numbers, passwords, and other personal information are protected from theft or misuse. In this section, we'll explore some of these challenges and describe a number of the efforts being made to meet them.

16.7: Careers in Information Management

Learning Objective

1. Identify career opportunities in information management.

The number and variety of opportunities in the IS field have grown substantially as organizations have expanded their use of IT. In most large organizations, the senior management team includes a *chief information officer (CIO)* who oversees information and telecommunications systems. A large organization might also have a *chief technology officer* who reports to the CIO and oversees IT planning and implementation.

Most entry-level IS jobs require a business degree with a major in information systems. Many people supplement their IS majors with minors in computer science or some other business area, such as accounting, finance, marketing, or operations management.

If you're starting out with an IS degree, you may choose to follow either a management path or a technical path. At Kraft Foods, for example, IS professionals can focus on one of two areas: applications development (a management focus) and information technology (a technology focus). "Applications development," according to the company itself, "calls for an ability to analyze [Kraft's] clients' needs and translate them into systems applications. Information technology calls for the ability to convert business systems specifications into technical specifications and to provide guidance and technical counsel to other Kraft professionals" (Kraft Foods, 2006). Despite the differences in focus, Kraft encourages IS specialists to develop expertise in both areas. After all, it's the ability to apply technical knowledge to business situations that makes IS professionals particularly valuable to organizations. (By the way, if you want a career in casinos, you can major in casino management at a number of business schools.)

Key Takeaways

- The number and variety of opportunities in the information systems (IS) field have grown substantially as companies have expanded their use of information technology.
- The senior management team in large organizations includes a chief information officer who oversees information and a chief technology officer who oversees IT planning and implementation.
- Most entry-level IS jobs require a business degree with a major in information systems.
- Many supplement their IS majors with computer science or some other business area, such as accounting, finance, marketing, or operations management.
- Those entering organizations with IS degrees may choose to follow either a management or a technology path.

Exercise

(AACSB) Reflective Skills

Why is studying IT important to you as a student? How will competency in this area help you get and keep a job in the future?

References

Kraft Foods, "Careers at Kraft: Information Systems," Kraft Foods, http://www.kraftfoods.com/careers/careers/systems.htm (accessed June 2, 2006).

16.8: Cases and Problems

Learning on the Web

Taking Care of Your Cyber Health

It seems that some people have nothing better to do than wreak havoc by spreading computer viruses, and as a computer user, you should know how to protect yourself from malicious tampering. One place to start is by reading the article "How Computer Viruses Work," by Marshall Brain, which you can access by going to the How Stuff Works Web site (http://computer.howstuffworks.com/virus.htm). After reading the article, answer the following questions:

1. Why do people create viruses?
2. What can you do to protect yourself against viruses?

Career Opportunities

Could You Manage a Job in IT or IS?

Do you have an aptitude for dealing with IT? Would you enjoy analyzing the information needs of an organization? Are you interested in directing a company's Internet operations or overseeing network security? If you answered yes to any of these questions, then a career in IT and IS might be for you. Go to the U.S. Department of Labor Web site (www.bls.gov/oco/ocos258.htm) and learn more about the nature of the work, qualifications, and job outlook in IT and IS management. Bearing in mind that many people who enter the IT field attain middle-management positions, look for answers to the following questions:

1. What kinds of jobs do IT managers perform?
2. What educational background, work experience, and skills are needed for positions in IT management?
3. What's the current job outlook for IS and IT managers? What factors drive employment opportunities?
4. What's the median annual income of a mid-level IT manager?

Ethics Angle (AACSB)

Campus Commando or Common Criminal?

Do you want to be popular (or at least more prominent) on campus? You could set up a Web site that lets fellow students share music files over the campus network. All you have to do is seed the site with some of your own downloaded music and let the swapping begin. That's exactly what Daniel Peng did when he was a sophomore at Princeton. It was a good idea, except for one small hitch: it was illegal, and he got caught. Unimpressed with Peng's technological ingenuity, the Recording Industry Association of America (RIAA) sued him, and he was forced to settle for $15,000. Instead of delivering music, Peng's Web site now asks visitors to send money to help defray the $15,000 and another $8,000 in legal costs.

To learn more about the case, read these articles from the Daily Princetonian: "Peng, RIAA Settle Infringement Case" (www.dailyprincetonian.com/2003/05/02/8154/), and "Peng '05 Sued by Recording Industry for 'Wake' Site" (www.dailyprincetonian.com/2003/04/04/7791).

After researching the topic, answer the following questions:

1. The practice of sharing commercial music files is illegal. Do you think that it's also unethical? Why, or why not?
2. What steps to curb the practice are being taken by the music industry? By college administrators? By the government? Do you approve of these steps? Have they been effective?
3. What, ultimately, do you see as the solution to the problem?

Source: Josh Brodie, "Peng, RIAA Settle Infringement Case," *The Daily Princetonian*, www.dailyprincetonian.com/2003/05/02/8154/ (accessed November 14, 2011); Zachary Goldfarb and Josh Brodie, "Peng '05 Sued by Recording Industry for 'Wake' Site," *The Daily Princetonian*www.dailyprincetonian.com/2003/04/04/7791/ (accessed November 14, 2011).

Team-Building Skills (AACSB)

CampusCupid.com

It's no secret that college can be fun. For one thing, you get to hang around with a bunch of people your own age. Occasionally, you want to spend time with just one special someone, but finding that special person on a busy campus can take some of the fun out of matriculating. Fortunately, you're in the same love boat with a lot of other people, so one possible solution—one that meshes nicely with your desire to go into business—is to start an online dating service that caters to your school. Inasmuch as online dating is nothing new, you can do some preliminary research. For example, go to the Internetnews Web site (http://www.internetnews.com/ec-news/article.php/2228891/Online+Personals+Big+Profits+Intense+Competition.htm) and read the article "Online Personals: Big Profits, Intense Competition."

Next, you and several of your classmates should work as a team to create a business model for an online dating service at your school. After working out the details, submit a group report that covers the following issues:

1. *Services*. How will you earn revenues? What services will you offer? How will you price these services? What forms of payment will you accept? Will you sell ads? If so, what kinds?
2. *Appearance*. What will your site look like? Will it have graphics? Sound? Video? What will your domain name be? What information will you collect from customers? What information will you provide to visitors?

3. *Operations*. What criteria will you use to match customers? How will your customers interface with the Web site? How will they connect with each other? Will you design your own software or buy or lease it from vendors? Before you answer, go to these vendors' Web sites and check out their dating software:

- WebDate (www.webscribble.com/products/...te/index.shtml)
- PG Dating (www.datingpro.com/dating)

4. *Attracting Customers*. How will you attract customers to the site? How will you monitor and analyze site activity?
5. *Security*. How will you guarantee confidentiality? How will you ensure that your site is secure? How will you limit access to students at your school?
6. *Opportunities and Challenges*. What opportunities do e-businesses offer? What challenges do they create? How would your business model change if you decided to run it as a traditional business rather than as an e-business?

The Global View (AACSB)

"Hong Kong—Traditional Chinese"

Hewlett-Packard (HP) provides technology solutions to individuals, businesses, and institutions around the world. It generates annual revenues of $80 billion from the sale of IT products, including computers, printers, copiers, digital photography, and software. Anyone in the United States who wants to buy an HP product, get technical support, download software, learn about the company, or apply for a job can simply go to the HP Web site. But what if you live in Hong Kong? How would you get answers to your questions? You'd do the same thing as people in this country do—go to HP's Web site.

Try to imagine, however, the complex process of developing and maintaining a Web site that serves the needs of customers in more than seventy countries. To get a better idea, go to the HP Web site (www.hp.com). Start by looking at HP's line of notebooks and checking its prices. Then, review the company information (click on "About HP" in the bottom right) that's posted on the site, and, finally, look for a job—it's good practice (click on "Jobs" in the bottom right).

Now pretend that you live in Hong Kong and repeat the process. Start by going to the same HP Web site (www.hp.com). Click on the United States (next to U.S. flag in the bottom left) and then Asia and Oceania. If you can read Chinese, click on "Hong Kong—Traditional Chinese." Otherwise, click on "Hong Kong—English." Then, answer the following questions:

1. How easy was it to navigate the site and to switch back and forth between the U.S. and Hong Kong sections of the site?
2. Identify at least five differences between the two sections.
3. Does HP's Web site meet the needs of customers in both the United States and Hong Kong? Why, or why not? How could it be improved?

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